file under
"Trust Cos"

REVIEW OF THE BANK ACT
(1977)

A BRIEF SUBMITTED TO THE DEPARTMENT OF FINANCE
GOVERNMENT OF CANADA

by

THE TRUST COMPANIES ASSOCIATION OF CANADA
L'ASSOCIATION DES COMPAGNIES DE FIDUCIE DU CANADA

REVIEW OF THE BANK ACT (1977)

A BRIEF SUBMITTED TO THE DEPARTMENT OF FINANCE
GOVERNMENT OF CANADA

by

THE TRUST COMPANIES ASSOCIATION OF CANADA
L'ASSOCIATION DES COMPAGNIES DE FIDUCIE DU CANADA

Prepared and written by

NICOLAS MATOSSIAN, M.B.A., Ph.D.
Economic Consultant to the Trust Companies Association of Canada

October, 1975.

TABLE OF CONTENTS

LIST OF TABLES FROM BANK ACT SUBMISSION

ACKNOWLEDGEMENTS

The Trust Companies Association of Canada also wishes to express its thanks to the following individuals for their assistance in the preparation and formulation of the brief:

K. A. WHITE	J. SAYERS
J. F. CLOSE	G. G. BRIANT
A. C. C. HEDGE	A. M. BELFIE
G. R. SHARWOOD	M. B. HARDING
W. W. POTTER	A. R. MARCHMENT

as well as its appreciation to chief executive officers and executives of member companies for their expert contributions.

I INTRODUCTION

The present brief is intended to state the position of the trust and loan companies of Canada to the Department of Finance of the Government of Canada with respect to the forthcoming revision of the Bank Act.

In this submission we assess the past and present role of the trust and loan companies both within the economic context and within the institutional structure of our financial system. We address ourselves to situations which can only be resolved through bank legislation and concurrently we examine the nature of banking and banking practices.

Our recommendations are intended to improve the overall effectiveness and efficiency of our financial system. We have consequently assessed the situation with a view to generating changes which will maximize opportunities and minimize constraints.

II TRUST AND LOAN COMPANIES: ECONOMIC BACKGROUND

THE HISTORY AND DEVELOPMENT OF TRUST AND MORTGAGE LOAN COMPANIES

A. History: Pre-1945

As the establishment of mortgage loan companies preceded that of trust companies, we shall consider the former first.

i. Mortgage Loan Companies

The earliest predecessors of today's mortgage loan companies were established by 1855. They had the power to lend to those wishing to build homes rather than to make personal loans or invest in securities. Later legislation expanded the scope of these powers, enabling mortgage loan companies to borrow from the public in order to raise funds.

The period ending approximately in 1891 was a period of sustained growth for these companies. The assets of mortgage loan companies grew at a rate of 11-1/4% per annum between 1870 and 1891, and by that time, their assets amounted to 24% of the assets of all recorded financial intermediaries. During 1870, in particular, these firms experienced unprecedented growth as 63 new firms entered the industry and the average value of assets per company doubled. From about 1891, however, the industry experienced very little growth until after 1945. The effect of this was that by 1944 their share of the assets of all financial intermediaries had fallen to 2%. Consequently, the number of mortgage companies fell from the 1895 peak of 95 firms to approximately 40 firms in 1945.

Several factors account for this varied growth pattern between 1855 and 1945. E.P. Neufeld suggests that:

> "The forces behind the period of expansion up to 1891 were the successful evolution of terminating building societies into permanent societies and so the successful emergence of loan companies; the development of standard and reliable procedures for valuing real estate and land; the unusually strong demand for mortgage money, particularly farm mortgage money, as reflected in high interest rate levels in Canada for much of that period; the development of the sterling debentures and the resulting decline in borrowing costs relative to lending rates; and, finally, the absence until the later part of that period of competitors in mortgage lending.[1]

Several other forces combined after 1891 to work against the expansion leading up to this date. The most significant was the greatly increased relative importance of life insurance companies and trust companies in the financial system in general and in the mortgage market in particular. The assets of life insurance firms equalled mortgage loan company assets by about 1902. Trust companies not only had all the borrowing and deposit advantages of loan companies but also enjoyed fiduciary powers on which they could build their estates, trusts and agency business. Thus, trust companies had some powers that mortgage loan companies did not have. Two other factors explain the mortgage loan companies' inability to compete in the mortgage market against life insurance companies, and in both the mortgage and debenture markets against trust companies. First, the spread between borrowing costs in the United Kingdom and lending revenues in Canada narrowed substantially between 1891 and 1945. This greatly reduced the unique advantage the mortgage loan companies enjoyed in having access to the United Kingdom capital market. When they also failed to develop adequate sources of funds in Canada during this

---

1. E. P. Neufeld, **The Financial System in Canada,** MacMillan (Toronto, 1972). p. 217.

same period, the life insurance and trust companies, as well as the chartered banks, quickly moved in to fill the gap. Second, the mortgage loan companies continued to focus their attention on farm mortgage financing during this period although at that time it was declining greatly in importance while the financing of urban residential and corporate property was gaining in relative terms.

As previously noted, the assets of the mortgage loan companies again began to grow after the Second World War. Before any discussion of the more recent developments of the trust and mortgage companies, however, we must consider the early history of the trust companies.

ii. Trust Companies

Canada's first trust company was incorporated in Ontario in 1882. It carried out two functions: firstly, as already noted, it undertook intermediary business similar to that of mortgage loan companies. Secondly, it provided executor, trustee and agency services. This second function constituted the trust company's unique contribution to the financial system and this function, above all others, distinguished it from mortgage loan companies.

Prior to 1967, the trust companies had three periods of rapid absolute and relative growth: from their formation up to 1913, from 1921 to 1930, and from 1945 to the present. Discussion of this last period is postponed until the later section on the development of trust and mortgage loan companies. Since these earlier two periods provide the historical background for trust companies they are dealt with at this point.

In these two early periods the growth of their assets in current dollars ran well ahead of their 1900 to 1968 annual average of 9-1/2%. Furthermore, in each of these two periods trust companies grew faster than all public and private intermediaries combined, and all "close" competitors combined, outstripping the growth of assets of the chartered banks.

The first period of rapid growth of the trust companies was based on the growth of their estates, trusts and agencies business, and on the capital funds required to support that business. In 1915, estates, trusts and agencies funds were twelve times the size of company and guaranteed funds. Subsequently the relative importance of their financial intermediary business increased rapidly.

By the end of their second period of growth — i.e. 1921-1930 — their sales of guaranteed investment certificates and receipts had been well developed and amounted to 54% of their company and guaranteed funds, of which shareholder's equity accounted for another 23%. When this is compared with the 84% accounted for by shareholder's equity in 1915, the phenomenon of increased leverage that usually accompanies a financial intermediary as it moves from early establishment and development to sustained growth becomes evident. During the 1920's the trust companies moved strongly into the financial intermediary business. The net effect was that mortgages accounted for 52% of total funds in 1925, and 45% in 1930, as these firms provided mortgage loan companies with competition in both the accumulation of funds and in mortgage lending activities. This growth stemmed from a logical extension of facilities required for their trustee business. Historically, trust companies' intermediary business was built on the base of the fiduciary business acquired in their earliest period of growth.

In contrast to these periods, however, were periods of slow growth. These effectively curtailed the relative size of the trust companies at a level far below their potential. For example, in 1930, the end of the second period of rapid growth, their assets were only 4.4% of total financial intermediary assets and only 4.7% of private financial intermediary assets.

B. Development: 1945-1967

The years between 1945 and the 1967 Bank Act Revision are considered to be the "development" years of the trust and mortgage loan companies for the purpose of this brief. 1945 is chosen as the cut-off point from the preceding development for reasons explained below.

The development of mortgage loan companies during these post-war years is dealt with first and then the development of the trust companies.

i. Mortgage Loan Companies

After the Second World War the assets of the mortgage loan companies again began to grow at an average annual rate of 10-3/4% between 1944 and 1968. This was slightly higher than the 9% recorded for all financial intermediaries combined. During this same period, however, the number of companies declined. In 1947 the federal Superintendent of Insurance's report included 40 federal and provincial mortgage loan companies. By 1961, the number had declined to 24. A short period of increased interest in the formation of mortgage loan companies followed with the result that by 1965 the total was 36 firms.

The post-war period brought no change in the traditional concentration of the mortgage loan companies on mortgage financing, other than the final completion of the shift away from farm mortgages that had begun in the 1930's. Supporting this growth pattern and evidencing a recognition of the growing need for mortgage financing was the progressive raising of the upper limit of loan to value ratio for conventional mortgages from 60% to 66-2/3% in 1961 and to 75% in 1965.

ii. Trust Companies

The post-war developments within the trust industry were among the most significant in the Canadian capital market during this period. The industry attained a relatively high rate of growth. Prior to the 1967 Bank Act, some trust companies were moving into close relationships with chartered banks. Some moved into close relationships with finance companies and real estate brokerage firms. New services such as pooled trust, pension funds and investment fund facilities were developed. There was innovation in the establishment of branches in supermarkets and shopping-centres. Better service to the customer in the form of more convenient business hours than those offered by the chartered banks was emphasized.

Prior to 1958 the growth rate of trust company assets experienced the same rate as that for total financial intermediary assets. But beginning in 1958 the trust companies annually exceeded the growth rates of all other financial intermediaries. The years of rapid growth following 1958 were also years when new trust companies were continually being incorporated.

In 1947 there were sixty trust companies of which forty-five were provincially incorporated and accounted for 76% of total assets (company and guaranteed funds). The number of companies declined until 1958 when there were only forty-eight in total. The period of expansion then began with the result being that by 1965 there were sixty-five companies. Provincially incorporated trust companies accounted for fifty-seven of these sixty-five firms. Surprisingly, however, in 1965 these provincially incorporated companies accounted for only about 66% of total assets. Much of this decline from the 1947 level of 76% is attributable to the Toronto General Trusts Corporation, an Ontario company, merging in 1961 with the Canada Permanent Trust Company, a federal company.

The post-1958 increase in the total number of trust companies has been accompanied by a substantial increase in the number of branches. In 1952 there were just under 200 offices. By 1967 the number of branch offices was in excess of 500.

As the number of trust companies and branches grew during the 1960's, so did the number of new services offered to the public. In the early 1960's several firms announced plans under which they would provide combined first and second mortgage financing in one loan agreement. Trust companies also moved to provide an alternative to mutual funds during the 1960's. In 1964 one trust company acquired a major real estate brokerage firm. In October 1967 another announced that it would start making personal loans under the basket clause provisions of trust company legislation.

All these developments suggest that considerable initiative in the development of a number of aspects of their business existed among trust companies during the 1950's and 1960's. The exercise of this initiative resulted in new consumer demands being met.

The industry's high growth rate during this period produced concurrent developments in the companies' structure of assets and liabilities.

On the liabilities side, loans from banks virtually disappeared as a source of funds. The relative importance of demand deposits also declined. On the other hand, guaranteed investment certificates and receipts (which represent for the most part term borrowings from 1-5 years) grew in relative size until by 1970 they accounted for a record level of 60% of total company and guaranteed funds.

On the asset side, holdings of Government of Canada securities fell from 40% of total assets in 1945 to about 10% thereafter. In addition, the companies' collateral loans never recovered the relative size they had in the 1920's; but their holdings of corporate and other non-government securities increased in relative importance until 1960. However, the most important development on the asset side concerns mortgages. Trust companies have traditionally favoured investments in mortgages. Mortgage investments accounted for 52% of total funds in 1925 and 45% in 1930. By 1970 the channelling of funds received via guaranteed investment certificates and receipts had increased this figure to 58% of total funds.

In summary, the investment in mortgages of funds obtained via guaranteed investment certificates and receipts was the major factor behind the trust companies' post-war growth. Furthermore, this same factor — mortgage investments — underlines the fact that since the Second World War the importance of the trust companies' financial intermediary role relative to their estates, trusts and agencies role has been continually increasing.

While the trust companies' growth in this period can easily be attributed to their shift toward mortgage investments during a period when this lending market was expanding faster than any other and when the chartered banks were excluded until the 1967 Bank Act Revision, two other factors need to be considered as well. First, during this period, the success of the trust companies indicated a gap in the provision of local financial services by the chartered banks. Second, the growth of trust companies into a financial intermediary role was a natural evolutionary move from their Estates, Trusts and Agencies (E.T. & A.) role.

The gap in the provision of local financial services existed for several reasons. First, the density of chartered bank branches was lower in the years following 1945 than in all previous years since 1910. In 1920, there were 1.0 thousand people per branch. In 1930 this rose to 2.5 thousand people per branch. By 1940 this figure had risen to 3.4. It peaked in 1950 at 3.7 and has since declined somewhat to a current level of 3.2.[1] It is conceivable that the expansion of trust company branches during this same period helped to fill this gap. Second, as the post-war practice was to provide banking service from 10 AM to 3 PM, Monday to Friday, it is also conceivable that the trust companies filled a gap by staying open longer and by opening on Saturdays.

---

[1] In June 1975, 6948 domestic bank branches served a population of 22.5 million. **Canadian Bankers' Association.** The President's Report, June 1975.

As indicated above, the principal reason for the increasing importance of the industry's financial intermediary role was its increased emphasis on mortgage investment, which is a logical extension of the industry's individual and corporate trustee, or E T & A function.

Trust and loan companies have gradually extended their activities into personal financial services. The development can be traced logically: the proper handling of trust and estate business leads directly to management of the total financial needs of individuals, for example, portfolio management, pooled investment vehicles, mortgage origination, managing or selling real estate, offering demand and term deposit facilities as a corollary for doing so for estates and trusts.

This evolution appears to be rational and desirable since estates and trusts generally comprise savings in the form of real property and securities which need to be managed in the best interests of the client. The beneficiary of an estate or trust will normally find it more efficient and probably less expensive to have the estate or trust and the properties and securities therein handled in one location. Trust companies have had to develop facilities to provide all the services indicated above, and the extension of this developed capacity to a wider clientèle resulted in economies of scale and a wider availability of expertise.

In summary, it may be said that the evolution of trust and loan companies' operations to their present status not only follows a logical pattern but also has responded to a genuine demand and the industry's success offers strong indications that it has served the public needs in an efficient and economic manner.

2. RECENT DEVELOPMENTS AFFECTING THE TRUST AND MORTGAGE LOAN INDUSTRY FROM 1967 TO DATE

This portion of the brief deals with the years following the 1967 Bank Act Revision. There are both macro-economic and micro-economic aspects to the developments within this period. The macro-economic aspects concern the changes in the structure and growth of the Canadian capital market since 1967. The micro-economic aspects focus on the trust and mortgage loan industry specifically and outline the highlights of their growth, structure and profitability during these years.

A. The Canadian Capital Market

Chartered banks, trust companies, credit unions, insurance companies, among others are all conventionally considered to be financial intermediaries, or at least to act as such. But if financial intermediation is simply understood to be the process of channelling funds between ultimate lenders and ultimate borrowers then the government must also be considered to be a financial intermediary. That is, governments borrow funds by issuing bonds and bills, and lend funds to institutions such as Central Mortgage and Housing Corporation. Furthermore, with the recent proliferation of Canada Savings Bonds, government financial intermediation has undergone a substantial change. It now borrows funds at the "shortest" or "least risky" end of the intermediation spectrum. Its lending activity, however, has a large concentration at the "high-risk" end, through the various lending facilities of the Department of Industry, Trade and Commerce, DREE grants and others. Accordingly, when considering the present Canadian capital market, the increasing tendency of the distribution of assets between the public and private sectors to favour the public sector needs to be considered, and perhaps with some concern.

From 1967 to 1974 total public and private Canadian dollar assets rose from 89.1 billion dollars to 183.4 billion dollars. (See Table IX)

i. Public Sector:

In 1967 the public sector had 22.1% of financial intermediary assets leaving the private sector with 77.9%. By 1973 the private sector fell to 75.3%. During this period the public sector reached a peak of 25.1% in 1970. The significance of this trend is that it amounts to a long run increase in public asset mobilization in a time of potential shortage of capital, and consequently to a danger of capital allocation control by government at the expense of the prevailing market system.

The major factor accounting for this relative increase in size of the public sector is the growth in the Canada Pension Plan. In 1967 it accounted for 1.5% of total public and private financial intermediary assets. By 1973 its share had risen to 3.8%. The growth in the Caisse de Dépôt which manages both the Quebec and other pension funds in the Province, is also responsible for some of the public sector growth. The Canada Pension Plan and Caisse de Dépôt together represent an aggregate increase from 2.0% of total public and private financial intermediary assets in 1967 to 5.2% in 1973. The assets of the Bank of Canada, on the other hand, remained steady between 5 and 4.4% during the same period. Similarly, the annuity and pension account — the largest single unit in public sectors — also remained steady between 1967 and 1973 at 8.9% to 9.3%. The share of total assets accounted for by Central Mortgage and Housing Corporation was down to 3.6% by 1973, a .4% decrease from the 1967 level of 4.0%.

In 1967 five public institutions accounted for 89.2% of total public sector assets. They were the Bank of Canada, the Federal Annuity and Pension Account, Central Mortgage and Housing Corporation, the Canada Pension Plan and the Caisse de Dépôt. By 1973 these same five institutions accounted for 92.4% of total public sector assets. This indicates, among other things, that government has attained an increasing role as a financial intermediary in the pension field. In contrast, the private sector participation in the pension field is decreasing, relatively. This is evidenced by the decrease in trusteed pension funds as a percentage of total public and private financial intermediary assets.

Within the public sector itself, as can be seen from Table IV, the Canada Pension Plan has increased from 6.8% of public financial intermediary assets in 1967 to 15.5% in 1973. The Caisse de Dépôt went from 2.1% of public assets to 5.9% over the same period. The Bank of Canada has gone steadily downward from 22.3% of public assets in 1967 to 17.9% in 1973. The share of public assets held by Central Mortgage and Housing Corporation fell from 18% to 14.8% over the same period. The Federal Annuity and Pension Account's share also fell from 40% to 38.3% over this period.

ii. Private Sector

We have already pointed out that between 1967 and 1973 there was a relative decline in the private sector's share of the entire Canadian capital market. Despite this development there were still some relative gainers within the private sector. Table IV shows that chartered banks were the major gainers with their share of the total public and private financial intermediary assets increasing from 28.3% in 1967 to 30.7% in 1973. This was despite a brief decline in 1970 to 27.8%. The trust companies enjoyed a steady increase from 4.9% to 5.7% over the same period. The major losers during this period were the life insurance companies which declined from 14.5% in 1967 to 10.4% in 1973. This amounted to an aggregate loss of 28.3% over the period. The consumer loan corporations fell from 5.1% in 1967 to 3.7% in 1973 for an aggregate loss of 27.45%. Credit unions were up from 3.8% in 1967 to 4.8% in 1973. Investment companies were down from 4.7% to 3.9%. The loss in this area was in part excess of redemptions over sales and in part the lower market value of mutual funds. Trusteed pension funds and fraternal societies were also down over this period from 9.1% to 8.8% and .5% to .3% respectively.

Four private financial intermediaries (i.e. life insurance companies, chartered banks, trust companies and trusteed pension funds) accounted for 56.8% of public and private financial intermediary assets in 1967 but fell to 55.6% by 1973. This is accounted for largely by the drop in the life insurance companies' assets, but generally we can say that relative to the group of large public institutions mentioned previously the leading private financial intermediaries have suffered more.

Several significant trends are evident when we consider the private institutions strictly with respect to their share of the assets of private financial intermediaries. Table III indicates that chartered banks experienced a steady increase from 36.4% of private financial intermediary assets in 1967 to 40.7% in 1973. Trust companies rose from 6.8% to 7.8% while credit unions and caisses populaires increased their share from 5.9% to 7.6%. On the down side, life insurance companies experienced a steady decline between 1967 and 1973 from 18.6% of private financial intermediary assets to 13.0%. The share held by consumer loan and sales finance firms also fell over this period from 6.5% to 4.9%. By 1973 the investment companies found themselves down from a high of 6.7% in 1968 to 5.2% in 1973.

iii. Growth Rates:

The compound growth rates of these various institutions help to explain their relative market shares. However, compound growth rates are of greatest validity and significance only when they are considered in relation to the growth rates of the economic factors underlying their growth. Accordingly, we will look first at these factors and then at the annual compound growth rates of the public and private financial intermediaries.

The annual compound growth rate of Gross National Product from 1967 to 1973 was 10.2% and approximately 11% from 1967 to 1974. During the same period the growth of M_1[(1)] was 9.5% while M_2[(1)] and M_3[(1)] grew at 13% per annum to 1973. To 1974 there are slight changes with M_1 growth at 9% per annum, M_2 at approximately 13.3% per annum and M_3 at 14% per annum. This implies a recent shift of monetary assets from liquid, M_1 monetary instruments into time instruments.

In the aggregate, personal disposable income has grown at a compound rate of 11% from 1967 to 1973 and at about the same rate to 1974. On a per capita basis, in 1967 personal disposable income was $2,161.39. By 1973 it had risen to $3,600.25 and by 1974 to $4,073.21. These represent growth rates of 9% from 1967 to 1973 and 9.5% to 1974. Personal disposable income, therefore, has grown at a lesser rate than Gross National Product, at the same rate or less than M_1, and considerably less than the rates of M_2 and M_3. This leads to two significant conclusions.

First, that an increasing portion of Gross National Product is going into the public sector. Secondly, the fact that personal disposable income grew at the same rate as M_1 but not as fast as M_2 demonstrates a significant shift of personal assets into term instruments; the absolute size of term instruments having risen despite a drop in the relative portion of Gross National Product going into personal disposable income. Interest elasticity is the likely explanation of this development.

Turning to the growth rates of the financial institutions as outlined in Table VII, we find that there are several institutions with growth rates to 1973 and 1974 which exceed the growth rates of M_2, that is, a 13.3% average to 1974. The effect of this is that these financial intermediaries earned an improved net position in real asset terms. Chartered banks grew at 14.5% to 1973 and 15.5% to 1974. Trust companies grew at 15.8% to 1973 and 16.2% to 1974. Mortgage loan companies grew at 14% to 1973 and 13% to 1974. The credit unions and caisses populaires (local) grew at 17.5% to 1973 and 17% to 1974, while the credit unions and caisses populaires (central)

(1) See Appendix II

grew at 23% to 1973 and 1974. All the other institutions were relative losers over the years 1967 to 1974. Foremost among these losers were the life insurance companies with average growth rates of 6.9% to 1973. Furthermore, we find that all the relative gainers listed above also exceed the growth rate of M_2 and the growth rate for personal disposable income which was 9% to 1973 and 9.5% to 1974. The fire and casualty insurance companies also exceed personal disposable income with rates of 10.5% to 1973 and 11% to 1974.

Gross domestic savings increased from $5,539 million in 1969 to $11,855 in 1974 for a gain of 114%. This is equivalent to a 16% compound growth rate over the period. The only institutions, therefore, that have exceeded the growth in M_2 and roughly kept up with gross domestic savings are the chartered banks with 15.5% compounded and the trust companies with 16.2%. The mortgage loan companies at 13% fell somewhat below the M_2 and gross domestic savings rates. Interestingly, at the same time in the public sector the Canada Pension Plan and Caisse de Dépôt with their respective growth rates of 31% and 36% to 1973, registered performances far above the average compound growth rates for both M_2 and gross domestic savings over this same period.

TABLE I
PRIVATE SECTOR CANADIAN FINANCIAL INTERMEDIARIES

Canadian Dollar Assets 1967-74
($ Millions)

	1967	1968	1969	1970	1971	1972	1973	1974
Chartered Banks	25,199	38,939	31,000	33,616	39,958	46,650	56,455	68,506
Quebec Savings Bank	506	571	542	568	637	709	805	884
Life Insurance Companies	12,912	13,667	14,334	14,960	15,990	17,544	19,076	N/A
Fraternal Societies	488	506	503	518	578	542	593	N/A
Fire and Casualty Insurance Companies	2,304	2,516	2,758	3,088	3,370	3,794	4,202	4,845
Building Societies and Mortgage Loan Companies	2,772	2,978	3,292	3,778	4,159	4,777	5,913	6,743
Trust Companies (excluding Estates, Trusts & Agencies)	4,353	4,980	5,771	6,564	7,470	8,601	10,509	12,443
Consumer Loan & Sales Finance Companies (1)	4,501	4,927	5,652	5,502	5,595	6,282	6,826	7,924
Investment Companies (2)	4,216	5,164	5,400	5,451	6,560	7,565	7,168	6,657
Credit Unions & Caisses Populaires (local)	3,382	3,758	4,103	4,570	5,532	7,040	8,814	10,119
Credit Unions & Caisses Populaires (central)	459	520	562	658	849	1,324	1,611	1,910
Trusteed Pension Funds	8,068	8,972	10,003	11,059	12,461	14,050	16,171	N/A
Development and Other Financing Companies (3)	148	145	149	164	185	207	251	275
TOTAL	69,308	77,643	84,069	90,496	103,529	119,292	138,645	N/A

Sources:
E. P. Neufeld, **The Financial System of Canada;** Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006; Bank of Canada Review.

1. Includes consumer loan companies and sales finance companies as separately recorded in **Financial Institutions: Financial Statistics,** Statistics Canada, Cat. No. 61-006.
2. Includes Mutual Funds, Non-Resident Funds and Closed-end Funds.
3. i. Mortgage Investment Trusts are not included.
   ii. A change in the component companies necessitated estimating the value for 1974.

TABLE II
PUBLIC SECTOR CANADIAN FINANCIAL INTERMEDIARIES

Canadian Dollar Assets 1967-74
($ Millions)

	1967	1968	1969	1970	1971	1972	1973	1974
Bank of Canada	4,412	4,636	4,888	5,405	6,019	7,056	7,999	9,184
Post Office and Federal Government Savings	41	29	23	12	8	7	6	N/A
Federal Government Annuity and Pension Account	7,916	9,053	10,520	12,185	13,803	15,540	17,128	19,262
Industrial Development Bank	341	379	423	498	558	614	734	985
Farm Credit Corporation	955	1,085	1,161	1,213	1,244	1,289	1,464	N/A
Veterans Land Act Loans	383	423	472	493	503	505	512	N/A
Central Mortgage & Housing Corporation	3,567	3,961	4,428	4,981	5,685	6,239	6,610	N/A
Export Development Corporation	357	357	293	348	452	604	719	N/A
Canada Deposit Insurance Corporation (1)	32	32	31	11	10	10	10	N/A
Canada Pension Plan	1,353	2,108	2,832	3,844	4,778	5,793	6,934	N/A
Caisse de Dépôt et Placement du Québec	419	684	990	1,326	1,698	2,148	2,642	N/A
TOTAL	19,776	22,747	26,161	30,316	34,758	39,805	44,758	N/A

Sources:
Bank of Canada, **Review;**
Government of Canada, **Public Accounts.**

Note:
Provincial public institutions are omitted because of the incomparability of the various provincial public accounts.

(1) Public Accounts Statistics do not match Canada Deposit Insurance Corporation reports. For consistency Public Accounts Figures were used.

TABLE III
PRIVATE SECTOR CANADIAN FINANCIAL INTERMEDIARIES

Annual Percentage Distribution of Assets

(%)

	1967	1968	1969	1970	1971	1972	1973	1974
Chartered Banks	36.4	38.3	36.9	37.1	38.6	39.1	40.7	N/A
Quebec Savings Bank	.7	.7	.6	.6	.6	.6	.6	N/A
Life Insurance Companies	18.4	17.6	17.1	16.5	15.4	14.7	13.8	N/A
Fraternal Societies	.1	.7	.6	.6	.6	.5	.4	N/A
Fire and Casualty Insurance Companies	3.3	3.2	3.3	3.4	3.3	3.2	3.0	N/A
Building Societies and Mortgage Loan Companies	4.0	3.8	3.9	4.2	4.0	4.0	4.3	N/A
Trust Companies	6.8	6.4	6.9	7.3	7.2	7.2	7.8	N/A
Consumer Loan & Sales Finance Companies	6.5	6.3	6.7	6.1	5.4	5.3	5.2	N/A
Investment Companies	6.1	6.7	6.4	6.0	6.3	6.3	5.2	N/A
Credit Unions & Caisses Populaires (local)	4.9	4.8	4.9	5.0	5.3	5.9	6.4	N/A
Credit Unions & Caisses Populaires (central)	1.0	.7	.7	.7	.8	1.1	1.2	N/A
Trusteed Pension Funds	11.6	11.6	11.9	12.2	12.0	11.8	11.7	N/A
Development and Other Financing Companies	.2	.2	.2	.2	.2	.2	.2	N/A
TOTAL	100	100	100	100	100	100	100	N/A

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006

TABLE IV
PUBLIC SECTOR CANADIAN FINANCIAL INTERMEDIARIES

Annual Percentage Distribution of Assets

(%)

	1967	1968	1969	1970	1971	1972	1973	1974
Bank of Canada	22.3	20.4	18.7	17.8	17.3	17.7	17.9	N/A
Post Office and Federal Savings Bank	.2	.1	.1	.03	.02	.01	.01	N/A
Federal Government Annuity and Pension Account	40.0	39.8	40.2	40.2	39.7	39.0	38.3	N/A
Industrial Development Bank	1.7	1.7	1.6	1.6	1.6	1.5	1.6	N/A
Farm Credit Corporation	4.8	4.8	4.4	4.0	3.6	3.2	3.3	N/A
Veterans Land Act Loans	1.9	1.9	1.8	1.6	1.4	1.3	1.1	N/A
Central Mortgage & Housing Corporation	18.0	17.4	16.9	16.4	16.4	15.7	14.8	N/A
Export Development Corporation	1.8	1.6	1.1	1.1	1.3	1.5	1.6	N/A
Canada Deposit Insurance Corporation (1)	.2	.1	.1.	.03	.02	.02	.02	N/A
Canada Pension Plan	6.8	9.3	11.2	12.7	13.7	14.6	15.5	N/A
Caisse de Dépôt et Placement du Québec	2.1	3.0	3.8	4.4	4.9	5.4	5.9	N/A
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	N/A

Sources:
Bank of Canada, **Review;**
Government of Canada, **Public Accounts.**

(1) See note (1) Table II.

TABLE V
PRIVATE SECTOR CANADIAN FINANCIAL INTERMEDIARIES

Annual Percentage Change in Assets

(%)

	1967-68	1968-69	1969-70	1970-71	1971-72	1972-73	1973-74
Chartered Banks	14.8	7.1	8.4	18.9	16.7	21.0	21.3
Quebec Savings Bank	12.8	—5.1	4.8	12.1	11.3	13.5	9.8
Life Insurance Companies	5.8	4.9	4.4	6.9	9.7	8.7	N/A
Fraternal Societies	3.7	—1.0	3.0	11.6	—6.2	9.4	N/A
Fire and Casualty Insurance Companies	9.2	9.6	12.0	9.1	12.6	10.8	15.3
Building Societies and Mortgage Loan Companies	7.4	10.5	14.8	10.1	14.9	23.8	14.0
Trust Companies	14.4	15.9	13.7	13.8	15.1	22.2	18.4
Consumer Loan & Sales Finance Companies	9.5	14.7	—2.7	1.7	12.3	8.7	16.1
Investment Companies	22.5	4.6	1.0	20.3	15.3	—5.2	7.1
Credit Unions & Caisses Populaires (local)	11.1	9.2	11.4	21.1	27.3	25.2	11.1
Credit Unions & Caisses Populaires (central)	13.3	8.1	17.1	29.0	55.9	21.7	18.6
Trusteed Pension Funds	11.2	11.5	10.6	12.7	12.8	15.1	N/A
Development and Other Financing Companies	—2.0	3.5	10.1	12.8	11.9	21.3	N/A

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006

TABLE VI
PUBLIC SECTOR CANADIAN FINANCIAL INTERMEDIARIES

Annual Percentage Change in Assets

(%)

	1967-68	1968-69	1969-70	1970-71	1971-72	1972-73	1973-74
Bank of Canada	5.1	5.4	10.6	11.4	17.2	13.4	N/A
Post Office and Federal Savings Bank	29.3	20.7	47.8	33.3	12.5	14.3	N/A
Federal Government Annuity and Pension Account	14.4	16.2	15.8	13.3	12.6	10.2	N/A
Industrial Development Bank	11.1	11.6	17.7	12.0	10.0	19.7	N/A
Farm Credit Corporation	13.6	7.0	4.5	2.6	3.6	13.6	N/A
Veterans Land Act Loans	10.4	11.6	4.4	2.0	0.4	1.4	N/A
Central Mortgage & Housing Corporation	11.0	11.8	12.5	14.1	9.7	5.9	N/A
Export Development Corporation	0	16.5	18.8	29.9	33.6	19.0	N/A
Canada Deposit Insurance Corporation (1)	0	3.1	64.5	10.0	0	0	N/A
Canada Pension Plan	55.8	39.1	31.1	24.3	21.2	19.7	N/A
Caisse de Dépôt et Placement du Québec	63.2	44.7	33.9	28.1	26.5	23.0	N/A
Total Public Sector	15.0	15.0	15.9	14.7	14.5	12.4	N/A

Sources:
Bank of Canada, **Review;**
Government of Canada, **Public Accounts.**

(1) See note (1) Table II.

TABLE VII
PRIVATE SECTOR CANADIAN FINANCIAL INTERMEDIARIES

Annual Compound Growth Rates of Assets

	Compound % growth	Absolute % Change	
	1967-73	1967-73	1967-74
Chartered Banks	14.5	124.0	171.9
Quebec Savings Bank	5.8	59.1	74.7
Life Insurance Companies	6.9	47.7	N/A
Fraternal Societies	2.9	21.5	N/A
Fire and Casualty Insurance Companies	10.5	82.4	110.3
Building Societies and Mortgage Loan Companies	14.0	113.3	143.3
Trust Companies	15.8	141.4	149.9
Consumer Loan & Sales Finance Companies	7.1	51.7	76.0
Investment Companies	9.2	70.0	57.9
Credit Unions & Caisses Populaires (local)	17.5	160.6	199.2
Credit Unions & Caisses Populaires (central)	23.0	251.0	316.1
Trusteed Pension Funds	13.0	100.4	N/A
Development and Other Financing Companies	9.0	69.6	86.0

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006

TABLE VIII
PUBLIC SECTOR CANADIAN FINANCIAL INTERMEDIARIES

Annual Compound Growth Rates of Assets

	Compound % growth	Absolute % Change	
	1967-73	1967-73	1967-74
nk of Canada	11.0	81.3	N/A
st Office and Federal Savings Bank	—	—	N/A
deral Government Annuity and Pension Account	14.0	116.3	N/A
ustrial Development Bank	14.0	115.2	N/A
rm Credit Corporation	7.5	53.3	N/A
terans Land Act Loans	5.0	33.7	N/A
ntral Mortgage & Housing Corporation	11.0	85.3	N/A
port Development Corporation	13.0	101.4	N/A
nada Deposit Insurance Corporation (1)	—	—	N/A
nada Pension Plan	31.0	412.5	N/A
isse de Dépôt et Placement du Québec	36.0	530.5	N/A

rces:
k of Canada, **Review;**
vernment of Canada, **Public Accounts.**

See note (1) Table II.

TABLE IX

PRIVATE FINANCIAL INTERMEDIARIES

Annual Percentage Shares of the Total Financial Market

(%)

	1967	1968	1969	1970	1971	1972	1973	1974
Chartered Banks	28.3	28.8	28.1	27.8	28.9	29.3	30.7	N/A
Quebec Savings Bank	.6	.6	.5	.5	.5	.4	.5	N/A
Life Insurance Companies	14.5	13.6	13.0	12.4	11.6	11.0	10.4	N/A
Fraternal Societies	.5	.5	.5	.4	.4	.3	.3	N/A
Fire and Casualty Insurance Companies	2.6	2.5	2.5	2.6	2.4	2.4	2.3	N/A
Building Societies and Mortgage Loan Companies	3.1	3.0	3.0	3.1	3.0	3.0	3.2	N/A
Trust Companies	4.9	5.0	5.2	5.4	5.4	5.4	5.7	N/A
Consumer Loan & Sales Finance Companies	5.1	4.9	5.1	4.6	4.0	3.9	3.7	N/A
Investment Companies	4.7	5.1	4.9	4.5	4.7	4.8	3.9	N/A
Credit Unions & Caisses Populaires (local)	3.8	3.7	3.7	3.8	4.0	4.4	4.8	N/A
Credit Unions & Caisses Populaires (central)	.5	.5	.5	.5	.6	.8	.9	N/A
Trusteed Pension Funds	9.1	8.9	9.1	9.2	9.0	8.8	8.8	N/A
Development and Other Financing Companies	.2	.1	.1	.1	.1	.1	.1	N/A
SUB-TOTAL	77.9	77.2	76.2	74.9	74.6	74.6	75.3	N/A
PUBLIC FINANCIAL INTERMEDIARIES								
Bank of Canada	5.0	4.6	4.4	4.5	4.4	4.4	4.4	N/A
Post Office & Federal Savings Bank	0.04	0.02	0.02	—	—	—	—	N/A
Annuity & Pension Account	8.9	9.0	9.5	10.1	10.0	9.8	9.3	N/A
Industrial Development Bank	0.4	0.4	0.4	0.4	0.4	0.4	0.4	N/A
Farm Credit Corporation	1.1	1.1	1.1	1.0	0.9	0.8	0.8	N/A
Veterans Land Act Loans	0.4	0.4	0.4	0.4	0.4	0.3	0.3	N/A
Central Mortgage and Housing Corporation	4.0	3.9	4.0	4.1	4.1	3.9	3.6	N/A
Export Development Corporation	0.4	0.4	0.3	0.3	0.3	0.4	0.4	N/A
Canada Deposit Insurance Corporation(1)	0.03	0.03	0.02	—	—	—	—	N/A
Canada Pension Plan	1.5	2.0	2.7	3.2	3.5	3.6	3.8	N/A
Caisse de Dépôt et Placement du Québec	0.5	0.7	0.9	1.1	1.2	1.4	1.4	N/A
SUB-TOTAL	22.1	22.8	23.8	25.1	25.4	25.4	24.7	N/A
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	N/A
Absolute Total ($ Billions):	89.1	100.4	110.2	120.8	138.3	159.1	183.4	
Annual % Change in Assets:	12.7	9.8	9.6	14.5	15.0	15.3		
1967-73 % Change:		105.9%						
Annual Compound Growth Rate:		12.8%						

Sources:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006
Bank of Canada, **Review,**
Government of Canada, **Public Accounts.**

(1) See note (1) Table II

The Trust and Mortgage Loan Industry

I. Relative Size and Growth

The previous section illustrates that trust and mortgage loan companies are a major and growing factor in the Canadian capital market. The following highlights from the foregoing tables give a clear picture of the present strength of the industry itself.

In 1973, the trust and mortgage loan companies accounted for 8.9% of the total assets of public and private financial institutions in Canada. This represents a .9% increase over the 1967 level of 8.0%. More specifically, the trust and mortgage loan companies had 12.1% of the assets of private financial intermediaries in 1973. This compares favourably with the 10.8% they had in 1967. The annual compound growth rate of assets, between 1967 and 1973, for trust companies alone is 15.8% while the same rate for just the loan companies is 14.0%. From the trust company figures for annual percentage change in assets it is clear that the compound growth rate can be explained as incorporating a two year period of growth between 1967 and 1969 and then several periods of increased bank competition. This bank competition reduced the trust companies' annual percentage change in assets from the high of 15.9% in 1968-69 to 13.7% in 1969-70. This situation prevailed until 1972-73 when a rapidly expanding mortgage market enabled trust companies to record a 22.2% annual change in assets, which fell slightly in 1973-74 to 18.4%.

It is noteworthy that the trust and mortgage loan companies' growth has continued despite increased bank competition resulting from the 1967 Bank Act Amendments. Increased competition from banks is clear from the fact that the banks' proportion of assets for the total (i.e. public and private combined) financial system increased from its 1967 level of 28.3% to 30.7% in 1973. The corresponding proportions in the private sector alone were 36.4% in 1967 and 40.7% in 1973.

ii. Distribution of Revenue and Expenses

From the percentage distribution of revenue shown in Table XIV for trust and mortgage loan companies it is evident that mortgage loans are the main area of lending in which these companies engage. In 1974 the interest on mortgage loans amounted to 65.5% of the revenue income of trust and mortgage loan companies. The greatest revenue increase, however, has been in the commission from real estate sales. In 1970 these commissions amounted to 2.4% of revenue but by 1974 had increased to 7.2%. Nevertheless, while mortgage lending and real estate sales have increased steadily since 1970, the fees from trust companies' estate, trust and agency functions have decreased from 10.7% of revenue in 1970 to 7.2% in 1974.

That the emphasis of these companies on mortgage loans has been in accord with social demands and that these companies are instrumental in meeting these social demands is evident from the following data:

TABLE X

MORTGAGE LOANS OUTSTANDING BY PRINCIPAL PRIVATE LENDING INSTITUTION — 1974

($ Millions)

	Amount	%
Trust & Mortgage Loan Companies	14,825	48.8
Chartered Banks	6,025	19.8
Life Insurance Companies	9,500	31.4
Total	30,350	100.0

Source:
Housing Statistics, 1974
Statistical Services Division
Central Mortgage and Housing Corporation, Ottawa, March, 1975

TABLE XI

MORTGAGE LOANS APPROVED BY PRINCIPAL PRIVATE LENDING INSTITUTIONS

($Millions)

	Chartered Banks	Trust & Mortgage Loan Companies	Insurance Companies	Others	Total
1967	252.9	913.1	799.9	59.2	2,124.9
1968	446.5	1,295.8	844.8	114.1	2,701.2
1969	381.1	1,651.5	621.3	140.5	2,793.9
1970	509.8	1,528.2	455.9	133.9	2,627.7
1971	1,164.7	2,503.1	849.7	159.0	4,676.5
1972	1,634.4	2,143.8	1,042.9	183.6	6,004.7
1973	2,394.1	4,454.7	1,471.3	168.2	8,488.3
1974	2,034.3	3,790.9	1,171.9	128.1	7,125.3

Source:
Canadian Housing Statistics, 1974
Statistical Services Division
Central Mortgage and Housing Corporation, Ottawa, March, 1975

In summary, the trust and mortgage loan industry accounts for almost half of the mortgage loans held by private lending institutions and despite the recent substantial encroachment of the banks into this area the trust and mortgage loan companies have still been able to expand and help in meeting the demand for mortgages.

They will continue to do so provided they are:

(a) able to compete for funds in the market place,

(b) able to attract capital for expansion, by way of equity or subordinated notes,

(c) permitted an appropriate multiple of capital and reserves on a basis consistent with the experience and expertise of the industry.

TABLE XII
DISTRIBUTION OF REVENUE AND EXPENSES FOR TRUST COMPANIES

($ Millions)

REVENUE	**1967**	**1968**	**1969**	**1970**	**1971**	**1972**	**1973**	**1974**
INTEREST:	257.3	302.4	337.5	479.5	538.7	619.3	(760.8)	(1017.0)
i. Bonds and Debentures		(CONSOLIDATED FIGURES ONLY AVAILABLE PRIOR TO 1973)					141.6	151.2
ii. Mortgages							564.4	765.4
iii. Other							54.8	100.4
DIVIDENDS:	4.1	5.1	6.0	6.5	6.3	8.3	9.9	12.3
FEES AND COMMISSIONS:								
i. Estates, Trusts and Agencies	80.5	91.4	113.3	98.8	104.6	116.5	123.0	137.6
ii. Real Estate Sales Commissions				21.3	39.0	58.4	99.7	136.9
SUB-TOTAL				120.1	143.6	174.9	222.7	274.5
OTHER:	9.9	8.5	14.4	9.0	11.2	13.7	21.1	28.8
TOTAL REVENUE	351.8	407.4	471.2	615.1	699.8	816.2	1014.0	1332.6
EXPENSES								
SALARIES	N/A	N/A	79.7	86.7	97.2	118.8	131.8	156.4
COMMISSIONS	N/A	N/A	9.1	12.8	23.6	36.9	62.8	89.5
INTEREST	189.9	234.5	269.3	395.3	416.3	467.9	598.4	903.3
TOTAL EXPENSES (1)	331.4	386.6	445.3	587.5	611.8	711.0	904.4	1247.4

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006

(1) Amortization, depreciation, net premises operating expenses, provision for losses, and other expenses are included in total expenses, but not itemized.

TABLE XIII
DISTRIBUTION OF REVENUE AND EXPENSES FOR MORTGAGE COMPANIES

($ Millions)

REVENUE	**1967**	**1968**	**1969**	**1970**	**1971**	**1972**	**1973**	**1974**
INTEREST:	172.6	188.6	215.9	259.7	296.8	347.3	(434.9)	(552.2)
i. Bonds and Debentures	(CONSOLIDATED FIGURES ONLY AVAILABLE PRIOR TO 1973)						30.5	31.9
ii. Mortgages							391.6	496.5
iii. Other							12.8	23.8
DIVIDENDS:	7.0	9.8	9.1	25.5	15.3	13.5	15.6	17.8
FEES AND COMMISSIONS:								
i. Estates, Trusts and Agencies	1.1	1.3	1.5	.2	.6	.7	1.3	.2
ii. Real Estate Sales Commissions				.8	2.1	2.5	2.5	1.2
SUB-TOTAL				1.0	2.7	3.2	3.8	2.4
OTHER:	24.8	26.0	29.9	22.3	26.6	30.2	30.4	21.6
TOTAL REVENUE	205.5	225.7	256.4	308.5	341.4	394.2	484.7	594.0
EXPENSES								
SALARIES	N/A	N/A	16.9	16.9	17.9	20.1	27.3	29.8
COMMISSIONS	N/A	N/A	8.2	5.1	5.5	6.1	8.0	6.5
INTEREST	117.8	130.9	145.3	186.6	215.6	247.0	316.8	432.1
TOTAL EXPENSES (1)	182.0	202.4	232.8	266.7	277.7	320.3	401.1	516.7

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006

(1) Amortization, depreciation, net premises operating expenses, provision for losses, and other expenses are included in total expenses, but not itemized.

TABLE XIV
DISTRIBUTION OF REVENUE AND EXPENSES FOR TRUST AND MORTGAGE COMPANIES

($ Millions)

REVENUE	**1967**	**1968**	**1969**	**1970**	**1971**	**1972**	**1973**	**1974**
INTEREST:	429.9	491.0	553.4	739.2	835.5	966.6	(1195.7)	(1569.2)
i. Bonds and Debentures							172.1	183.1
ii. Mortgages		(CONSOLIDATED FIGURES ONLY AVAILABLE PRIOR TO 1973)					956.0	1261.9
iii. Other							67.6	124.2
DIVIDENDS:	11.1	14.9	15.1	32.0	21.6	21.8	25.5	30.1
FEES AND COMMISSIONS:								
i. Estates, Trusts and Agencies	81.6	92.7	114.8	99.0	105.2	117.2	124.3	137.8
ii. Real Estate Sales Commissions				22.1	41.1	60.9	102.2	138.1
iii Other:	34.7	34.5	44.3	31.3	37.8	43.9	51.4	50.4
TOTAL REVENUE	557.3	633.1	727.6	923.6	1041.2	1210.4	1498.7	1926.6
EXPENSES								
SALARIES	N/A	N/A	96.6	103.6	115.1	131.9	159.1	186.1
COMMISSIONS	N/A	N/A	17.3	17.9	29.1	43.0	70.8	96.0
INTEREST	307.7	365.4	414.6	581.9	631.9	714.9	915.2	1335.4
TOTAL EXPENSES (1)	513.4	589.0	678.1	854.2	889.5	1031.3	1305.5	1764.1

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006

(1) Amortization, depreciation, net premises operating expenses, provision for losses, and other expenses are included in total expenses, but not itemized.

TABLE XV
DISTRIBUTION OF REVENUE AND EXPENSES FOR TRUST AND MORTGAGE COMPANIES AS A PERCENTAGE OF TOTAL INCOME

(%)

REVENUE	1967	1968	1969	1970	1971	1972	1973	1974
INTEREST:	77.1	77.6	76.1	80.0	80.2	79.9	(79.8)	(81.4)
i. Bonds and Debentures							11.5	9.5
ii. Mortgages			(CONSOLIDATED FIGURES ONLY AVAILABLE PRIOR TO 1973)				63.8	65.5
iii. Other							4.5	6.4
DIVIDENDS:	2.0	2.4	2.1	3.5	2.1	1.8	1.7	1.6
FEES AND COMMISSIONS:								
i. Estates, Trusts and Agencies	14.6	14.6	15.8	10.7	10.1	9.7	8.3	7.2
ii. Real Estate Sales Commissions				2.4	3.9	5.0	6.8	7.2
OTHER:	6.2	5.4	6.1	3.4	3.6	3.6	3.4	2.6
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
EXPENSES								
SALARIES	N/A	N/A	14.2	12.1	12.9	12.8	12.2	10.6
COMMISSIONS	N/A	N/A	2.6	2.1	3.3	4.2	5.4	5.4
INTEREST	59.9	62.0	61.1	68.1	71.0	69.3	70.1	75.7
TOTAL EXPENSES (1)	N/A	N/A	77.9	82.3	87.2	86.3	87.7	90.7

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006

(1) These figures are less than 100 because amortization, depreciation, net premises operating expenses, provision for losses, and other expenses are not included.

iii. Distribution of Assets and Liabilities

Tables XVI and XVIII illustrate dramatic changes since 1967 in the trust companies' deposit liability distribution.

In recent years public demand has resulted in a more substantial growth in term deposits rather than demand deposits. In 1967, chequable deposits were equivalent to 49.2% of demand deposits, while non-chequable deposits accounted for the remaining 50.8%. These percentages have continually drifted down since then until chequable deposits fell to the 1974 level of 22.3% and non-chequable deposits rose to 77.7% of all demand deposits.

Another shift has taken place in the distribution of term deposits and guaranteed investment certificates. In 1967 the funds received from the public in this form divided as follows: 22.7% in liabilities maturing in less than one year; 76.1% in liabilities maturing in one to five years; and 1.2% in liabilities maturing in over five years. By 1974 these values had changed to 18.4%, 80.8% and .8% respectively. This amounts to a shift out of less than one year and over five year guaranteed investment certificates into those certificates maturing in one to five years.

Chequable deposits have decreased from 14.7% of total liabilities in 1967 to 4.3% in 1974. Non-chequable deposits, on the other hand, have remained constant at approximately 15%. Guaranteed investment certificates maturing in one to five years have increased from their 1967 level of 53.4% to 65.2% in 1974. This increase has been at the cost of liabilities maturing in less than one year and those maturing beyond five years. The former have decreased from 16% in 1967 to 14.9% in 1974. The latter have decreased from 0.8% in 1967 to 0.6% in 1974. The net result, as noted above, has been a shift out of chequable and non-chequable deposits into Guaranteed Investment Certificates and primarily into those with maturities of one to five years.

By considering each of the above categories as a percentage of total liabilities, rather than as percentages first of demand deposits and then as percentages of Guaranteed Investment Certificates, further changes in liability distribution become evident.

The first change to be noted is in the distribution of demand deposits relative to Guaranteed Investment Certificates. In 1967, demand deposit liabilities accounted for 29.8% of total demand and term (i.e. GIC) deposits. By 1974, this percentage fell to 19.3%.

The same trends are evidenced by examining the shifts in the trust companies' annual liability distribution as a percentage of total liabilities and not just total deposit liabilities. As a percentage of total liabilities, demand deposits have decreased from 26.9% in 1967 to 17.8% in 1974. During this same period, term deposits have increased as a percentage of total liabilities from 63.2% to 73.7%.

The asset side of trust company operations primarily reflects the increased emphasis on mortgage investments. As a percentage of total assets, N.H.A. mortgages and conventional mortgages were 55.6% in 1967 and have increased to 71.1% in 1974. This increase in mortgage investment was made possible by a simultaneous decrease in investments in the bond market. The percentage of trust company assets held in Government of Canada bonds has decreased from 10.2% in 1967 to 3.1% in 1974. Similarly, their provincial and municipal government bonds have decreased from 9.1% in 1967 to 3.4% in 1974, and their corporate bonds have decreased from 6.7% to 3.5% over the same period. In total, bond holdings as a percentage of total assets have decreased over 1967-74 from 26.0% to 10.0%.

During this period there was also increased emphasis on five year mortgages rather than the longer mortgage maturities. It had been the practice earlier to make loans with maturities based on the full period of amortization, often twenty years or longer. In recent years very few loans have been made for periods of longer than five years. Rising interest rates have heavily penalized the profits of those companies which had long maturities on the lending side. In general, the industry policy is to match maturities for assets and liabilities.

The above discussion deals strictly with trust companies and not with trust and mortgage loan companies. Mortgage loan companies need not be considered here in any depth as the same observations and conclusions made with respect of trust companies also apply to them.

TABLE XVI
ANNUAL LIABILITY DISTRIBUTION AS A PERCENTAGE OF TOTAL LIABILITIES: TRUST COMPANIES

(%)

LIABILITY DISTRIBUTION:	1967	1968	1969	1970	1971	1972	1973	1974
DEMAND DEPOSITS								
Chequable	13.2	11.6	7.7	6.2	6.1	6.2	5.2	4.0
Non-Chequable	13.7	13.2	15.7	16.3	16.4	16.8	14.1	13.8
TOTAL DEMAND DEPOSITS	26.9	24.8	23.4	22.5	22.5	23.0	19.4	17.8
TERM DEPOSITS AND GUARANTEED INVEST-MENT CERTIFICATES MATURING:								
Less than 1 year	14.3	16.1	18.3	14.6	13.4	12.5	11.1	13.6
1 - 5 years	48.1	48.1	48.3	52.6	54.9	55.2	60.5	59.6
Over 5 years	0.7	0.6	0.3	0.5	0.3	0.3	0.3	.5
TOTAL TERM DEPOSIT	63.2	64.8	66.9	67.7	68.6	68.0	71.9	73.7
OTHER LIABILITIES	1.8	2.6	2.5	3.1	2.5	2.7	3.0	3.2
SHAREHOLDERS EQUITY	8.1	7.8	7.2	6.7	6.4	6.3	5.7	5.3
TOTAL DEPOSITS	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006.

TABLE XVII
INDIVIDUAL ASSETS AS A PERCENTAGE OF TOTAL ASSETS: TRUST COMPANIES

(%)

	1967	1968	1969	1970	1971	1972	1973	1974
Cash and Marketable Securities	2.4	2.6	4.2	5.0	3.5	1.8	1.0	1.2
Term and Notice Deposits	4.2	4.4	1.8	3.1	4.0	6.8	8.1	6.9
Short-Term Paper	3.4	4.6	5.1	5.8	5.9	4.0	2.4	2.6
TOTAL CASH AND SHORT-TERM PAPER	10.0	11.6	11.1	13.9	13.4	12.6	11.5	12.7
Government of Canada Bonds	10.2	10.2	10.1	8.2	7.1	6.0	4.1	3.1
Provincial and Municipal Bonds	9.1	8.1	6.6	6.3	6.5	5.1	3.9	3.4
Corporate Bonds	6.7	6.4	5.7	5.1	5.3	4.9	4.7	3.5
TOTAL BONDS	26.0	24.7	22.4	19.6	18.9	16.0	12.7	10.0
N.H.A. Mortgages	11.6	11.0	10.3	11.0	12.4	14.1	14.0	12.7
Conventional Mortgages	44.0	43.7	46.3	47.3	47.5	49.3	54.4	58.4
TOTAL MORTGAGES	55.6	54.7	56.6	58.3	59.9	63.4	68.5	71.1
Personal and Collateral Loans	2.6	2.9	2.8	2.6	2.5	3.1	2.6	2.9
Canadian Equity Investments	2.0	2.0	1.9	1.6	1.6	1.7	1.6	1.8
Foreign Securities	0.3	0.4	1.1	0.4	0.3	0.2	0.1	.2
TOTAL OTHERS	4.9	5.3	5.8	4.6	4.4	5.0	4.3	4.9
TOTAL MAJOR ASSETS	96.5	96.3	95.9	96.4	96.6	97.0	97.0	98.7
OTHER ASSETS	3.5	3.7	4.1	3.6	3.4	3.0	3.0	1.3
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006.

TABLE XVIII
ANNUAL PERCENTAGE DISTRIBUTION OF INDIVIDUAL DEPOSIT LIABILITY CATEGORIES: TRUST COMPANIES

(%)

	1967	1968	1969	1970	1971	1972	1973	1974
DISTRIBUTION OF DEMAND DEPOSITS — by type:								
Chequable Deposits	49.2	46.9	32.7	27.4	27.0	26.8	27.0	22.3
Non-Chequable Deposits	50.8	53.1	67.3	72.6	73.0	73.2	73.0	77.7
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
DISTRIBUTION OF TERM DEPOSITS — by maturity:								
GUARANTEED INVEST-MENT CERTIFICATES MATURING IN:								
Less than 1 year	22.7	24.9	27.2	21.6	19.5	18.3	15.5	18.4
1 - 5 years	76.1	74.2	72.3	77.7	80.0	81.2	84.2	80.8
Over 5 years	1.2	.9	0.5	0.7	.5	0.5	0.3	.8
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
DISTRIBUTION OF DEMAND AND TERM DEPOSITS								
DEMAND DEPOSITS:								
Chequable Deposits	14.7	13.0	8.5	6.8	6.7	6.8	5.8	4.3
Non-Chequable Deposits	15.1	14.6	17.4	18.1	18.0	18.5	15.5	15.0
TERM DEPOSITS:								
GUARANTEED INVEST-MENT CERTIFICATES MATURING IN:								
Less than 1 year	16.0	18.0	20.1	16.2	14.7	13.7	12.2	14.9
1 - 5 years	53.4	43.7	53.6	58.4	60.3	60.7	66.2	65.2
Over 5 years	0.8	0.7	0.4	0.5	0.3	0.3	0.3	.6
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006.

TABLE XIX

ANNUAL PERCENTAGE DISTRIBUTION OF INDIVIDUAL LIABILITY CATEGORIES: MORTGAGE COMPANIES

(%)

	1967	1968	1969	1970	1971	1972	1973	1974
DISTRIBUTION OF DEMAND DEPOSITS — by type:								
Chequable Deposits	38.2	34.9	36.7	31.1	29.1	29.2	27.7	25.2
Non-Chequable Deposits	61.8	65.1	63.3	68.9	70.9	70.8	72.3	74.8
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
DISTRIBUTION OF TERM DEPOSITS — by maturity:								
DEBENTURES								
Less than 1 year	2.6	2.3	2.4	1.5	2.4	2.7	4.2	4.6
1 - 5 years	58.1	61.4	66.2	71.2	71.4	66.3	69.8	83.5
Over 5 years	39.3	36.3	31.4	27.3	26.2	31.0	26.0	11.9
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
DISTRIBUTION OF DEMAND AND TERM DEPOSITS								
DEPOSIT LIABILITIES:								
Chequable Deposits	7.4	7.0	6.8	5.4	5.0	5.1	4.2	3.5
Non-Chequable Deposits	12.0	13.2	11.6	11.9	12.3	12.4	10.9	10.3
DISTRIBUTION OF TERM DEPOSITS:								
GUARANTEED INVESTMENT CERTIFICATES MATURING IN:								
Less than 1 year	2.1	1.8	1.9	1.2	2.0	2.3	3.6	3.9
1 - 5 years	46.8	49.1	54.0	59.0	59.1	54.7	59.2	72.0
Over 5 years	31.7	28.9	25.7	22.5	21.6	25.5	22.1	10.3
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
LIABILITY DISTRIBUTION:								
Chequable Deposits	5.5	5.3	4.9	4.0	3.8	3.7	3.0	2.5
Non-Chequable Deposits	8.9	9.8	8.5	8.8	9.3	9.0	7.9	7.3
	14.4	15.1	13.4	12.8	13.1	12.7	10.9	9.8
TERM DEPOSITS AND GUARANTEED INVESTMENT CERTIFICATES MATURING IN:								
Less than 1 year	1.6	1.4	1.4	0.9	1.5	1.6	2.6	2.8
1 - 5 years	34.6	36.7	39.3	43.5	44.7	39.5	43.0	51.2
Over 5 years	23.4	21.7	18.7	16.6	16.4	18.4	16.0	7.3
Total Term Deposits	59.6	59.8	59.4	61.0	62.6	59.5	61.6	60.3
OTHER LIABILITIES	14.0	13.1	14.2	13.5	12.2	16.9	18.1	21.2
SHAREHOLDERS EQUITY	12.0	12.0	13.0	12.7	12.1	10.9	9.4	8.7
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006.

3. PERFORMANCE AND PROFITABILITY

In the preceding exposition of structural changes and fluctuations in the capital markets we have noted that a number of important events have taken place since the Bank Act was last revised. In this section we will attempt to correlate structural changes in capital markets, financial institutions and internal revenue sources to the profitability of trust and loan companies.

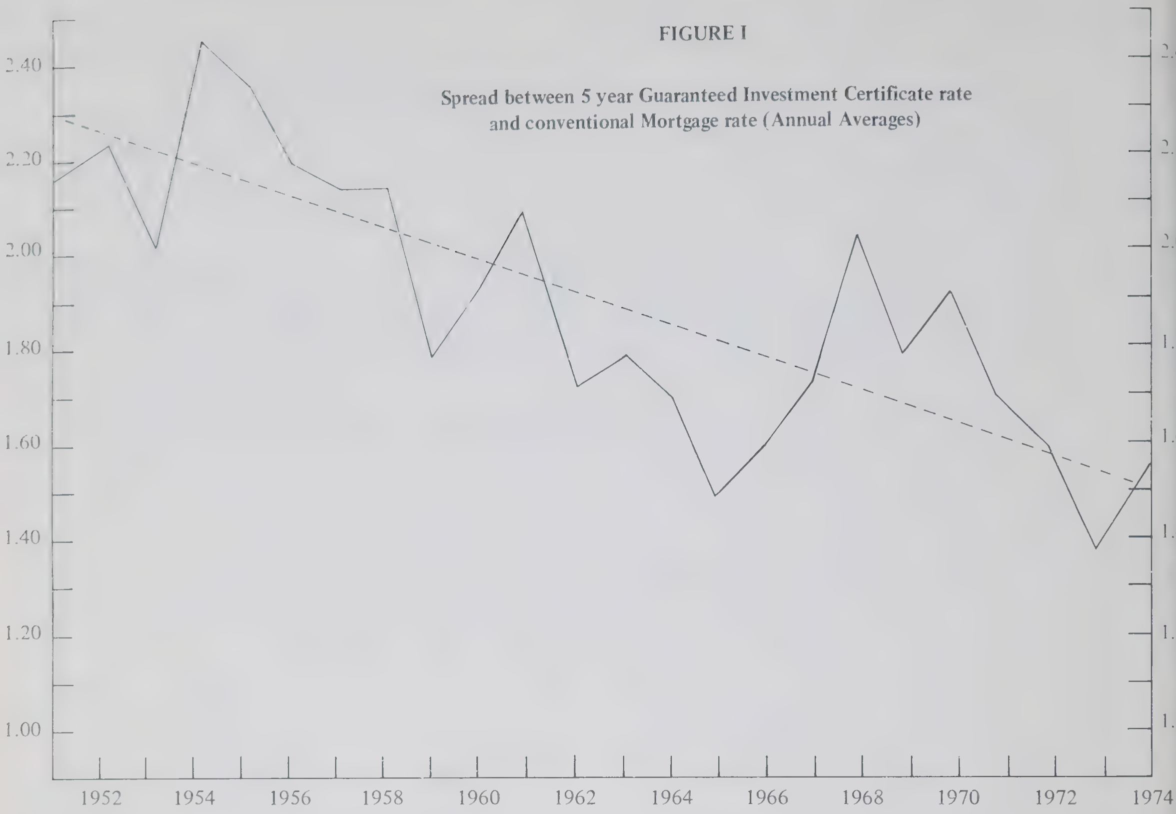
The long-run viability of a set of financial institutions depends on its ability to grow with demand. The competitive success of a set of institutions within the entire group of financial intermediaries making up the Canadian financial system is dependent on that set of institutions' ability to vie for an appropriate share of the Canadian market.

In order to keep up with demand, a financial institution constrained by legislation must increase its capital base to conform with regulations as its assets increase. This requires most financial institutions faced with a growing market to increase their capital base constantly. This may be done either through internally generated funds or through external capital on the open market, which is a highly competitive process where the firm's rate of return on its equity as well as the risk inherent to the firm are key factors. In the case of the trust and loan companies relative to other industries, risk is a lesser consideration since they have achieved a high standard of stability and consistency, both through practice and legislation. Thus return on equity is the investor's prime consideration when he examines the trust and loan industry.

Below we analyze the relationship between revenue structure changes and profitability in the first instance, profitability patterns relative to economic factors in the second instance, comparative profitability performance between the trust and loan companies and the chartered banks in the third instance and finally an indication of the relationship between growth capital requirements and the profitability record of the trust and loan companies.

A. Revenue Structure and Profitability

In the case of both trust companies and mortgage loan companies, mortgage revenue is the principal source, accounting for about two thirds of the total revenue of combined trust and loan companies. Absolute revenue has risen by over 20% between 1973 and 1974, reflecting both volume increase and higher mortgage interest rates. In the case of mortgage companies the case is fairly simple: because the vast majority of their revenue originates from mortgage interest, their performance is tied closely to the mortgage rate. It is evident from the statistical evidence that periods of rising interest rates will cause a reduction in net income to firms whose revenue originates from longer term mortgages and who have to finance these by rolling over shorter term money, or increasing demand deposit rates. Mortgage loan companies match maturities through the nature of their money raising procedures which correspond closely to their issuing of mortgages. The performance of mortgage loan companies is basically stable with the main problems arising from their single purpose. The lack of flexibility which mortgage loan companies have as to the use of their funds may give rise to a specific problem: mortgage rates appear to become interest inelastic over a certain range, starting approximately above 10%, and high mortgage rates to the consumer are politically unpalatable, consequently these rates may not climb as high as short term interest rates on consumer and commercial loans. Thus, financial institutions faced with an increase in their costs of funds can, if they have the flexibility, shift out of mortgages into consumer and commercial loans. What we have witnessed in the past year, and what we may well continue to experience is a rise in the short and long term borrowing rates with a distinct resistance to increased mortgage rates. Traditional spreads between Guaranteed Investment Certificates, for example, and mortgages have been severely eroded. (See Fig. I)



Trust companies are affected by the same problem to the extent that they derive a great majority of their revenue from mortgage sources. Trust companies differ, however, to the extent that they have their Estates, Trusts and Agencies business (E T & A) and their real estate sales activities to complement their mortgage income.

The significance of the fiduciary, and particularly the E T & A business to the trust companies, relative to their intermediary operations, and the problems of rapidly increasing expense in this area are not readily apparent from the consolidated figures shown in Table XII. This shows that while salary expenses have doubled in dollar terms from 1969 to 1974, they dropped from 14% to 10.6% of total expenses in this period. There are two important factors that require consideration to place these figures in the proper perspective:

a) The economies of scale available to the intermediary operations, both in mortgage investment and acquisition of liabilities, limit the percentage increase in salary expenses attributable to this area. The greater part of total salary expenses, and a high proportion of the increase between 1969 and 1974 is properly attributable to fiduciary business.

b) Interest expense, which rose from 61.8% to 75.1% from 1969 to 1974 as a percentage of gross income, was affected by the increase in interest rates as well as the greater volume of business. Table XX indicates that net financial income as a percentage of gross income net of interest costs, dropped from 42.1% to 37%, after peaking at 48.8% in 1973, the year of the industry's highest profitability to date.

The operating expense of an E T & A department has in fact risen enormously in comparison with the revenue derived, and the ability of fiduciary business to offset the volatility of earnings from intermediary operations is thus limited.

The E T & A business appears to suffer from severe cost problems which affect the overall performance of trust companies. In brief, the structure of fees generally fixed by the courts has changed slowly while the cost of providing fiduciary services has increased dramatically by virtue of the increase in complexity of the tax system and because estate and income taxes have considerably reduced the accumulation of wealth. Trust companies having to provide competent fiduciary services have been obliged to hire skilled and experienced staff to deal with the current accounting and fiscal problems associated with handling estates and trusts in our present day context.

While trust companies will agree that it is not profitable to handle estates and trusts of $100,000 or less, there has been a secular trend which has increased the number of small estates relative to larger ones. Typically, the composition of estates handled has shifted so that, in the example of one of the larger firms, more than 62% of individual accounts are of less than $100,000. At the same time, lagging stock and bond markets have kept down fees that are related to market values. Relative to an estimated $51 billion market or book value in 1974, comprising some $30 billion in personal trust assets and $21 billion in corporate, trust companies' gross revenue in fiduciary business amounted to a mere $137.6 million or about 1/5 of 1%. Thus, in the face of rising costs and limited revenues, trust companies will not be able to look forward to their E T & A business as a source of increasing net revenues and substantial cash generation to finance growth. It will nevertheless remain a stable source of revenue, gradually increasing and providing our social and economic system with a service which is both indispensable and available at a minimum cost.

The intermediation function of the trust and loan companies is accomplished by combining deposits in trust through a Guaranteed Funds Account. The provider of funds usually buys a Guaranteed Investment Certificate ranging in maturity from one to five years. The deposit is guaranteed by the corporation and secured by the company's assets. The profits are derived from the margin between the cost of funds and the revenue from the use of these funds. Typically, a trust company will issue GIC's on which it may pay an average of 10%; it will then hold the required liquidity in lower yielding securities, at say 6-1/2%, and hold the remainder in the form of 11½-12% first mortgages. Most companies operate with an objective of approximately 2% gross marginal spread and variations in profitability can therefore originate from three basic sources.

Firstly, the liquidity requirements lower the average return since the kind of securities required have traditionally been lower yielding instruments than first mortgages. Liquidity requirements are generally a net cost since the interest paid to the holder of the GIC usually exceeds the short term securities' yield. Thus, the greater the liquidity requirement as a proportion of total assets, the greater the reduction in gross margin.

Secondly, and more importantly, market conditions and the individual company's judgement as to interest rate expectations may play an extremely important role in profitability. This is well illustrated in the case of a company forced to abandon a policy of matching assets (5 year mortgages) with liabilities (5 year GIC's) in favour of shorter term deposits. Circumstances in the money market might dictate that when short rates are considerably below long rates, the industry will move away from matching its maturities towards borrowing short and lending long.

There are also economic periods, primarily periods of rising interest rate expectations, where long term GIC's are hard to sell and savers prefer to hold their deposits in the shorter term, regardless of rate. Thus, whether it may be from savers' unwillingness to commit their funds to the long term or the individual company's desire to increase its profitability, a situation may arise where a larger portion of trust and loan companies assets are of short term origin. This form of

leverage is a key factor in the industry's profitability: as an illustration a firm may have had substantial numbers of 25 year 7 percent first mortgages originating in the mid-sixties against 5 or 5-1/2% GIC's. Come the 1970's, it would have to roll over its sources of funds with 8 or 9% money. The problem is not as dramatic as it seems at first since principal repayments, incremental GIC volume and new business would dampen the effect, but it illustrates the danger of borrowing short and lending long, and the problem of inflexibility for an industry relying so heavily on a single type of asset.

For the industry as a whole, however, this effect has been and will continue to be felt as long as uncertainty about interest rates persists. The more individuals are concerned about their expectations the more likely they are to hold their assets in short term securities which provide them with the necessary flexibility should interest rates appear to stabilize or decline. There is a meaningful correlation between the rise in interest rates and the gradual shift into the shorter term GIC's. Based on the statistics available, the move is especially noticeable in the case of mortgage companies, with GIC's of 1-5 years rising from 58.1% of total liabilities in 1967 to 83.5% in 1974. There has been a marked increase in 1973-74 from 69.8% to 83.5%. The percentage of less than one year GIC's has also nearly doubled since 1967. Though the statistics in the tables do not show this, there is some individual evidence showing that the composition of the 1-5 years GIC portfolio has also changed over the period with the 1-2 year volume increasing considerably as compared with the 3 year to 5 year GIC volume.

The effect on profitability of this portfolio behaviour is especially noticeable when one examines certain specific time periods. In the 1972-1974 period for mortgage companies, the shift into short term instruments was the most dramatic and the financial spread consequently dropped from 1.3% to 0.78% in the first year and 0.78% to 0.35% in the second. The loss of some 102 basic points represents a significant squeeze attributable solely to a liability structure shift. As indicated earlier the revenue side is not as flexible on the upside since mortgage rates are interest inelastic over a certain range and consequently mortgage companies are affected directly and significantly. Trust companies experienced a similar squeeze over the same period. The problem illustrated here indicates that the single purpose of mortgage loan companies in their sources and uses of funds and of trust companies to a lesser extent results in a lack of flexibility causing severe financial squeezes in times of rising interest rates or uncertain expectations.

The third aspect which is crucial to profitability is the legislation governing leverage. Currently, the enabling legislation restricts trust and loan companies' assets to a multiple of their own capital and reserves and this leverage has been traditionally lower than that of the chartered banks, for example. Thus profitability related to invested capital does not achieve the high level of chartered banks. This is a statutory problem and not a matter of financial performance. It is relevant to say nevertheless that, as the legislation is relaxed and a higher leverage is permitted, trust and loan companies may be expected to become more profitable with the same equity base. The recent amendments permitting the issue of subordinated notes will assist in this respect.

B. Profitability and Economic Conditions

The profitability of trust and loan companies is affected by economic factors largely because of their capital structure and also because of the legal restrictions imposed on their uses and sources of funds.

Inflation and rising interest rates play havoc with savers' expectations and create substantial changes in the structure of capital markets. As interest rates rise (and are expected to continue rising) individuals shift their savings into the short term while at the same time trying to secure their liabilities on long term contracts. Thus, at the same time that people tend away from longer term GIC's toward the one year maturity there is a simultaneous attempt to secure the longest term mortgages available at the going rate. Trust and loan companies may be forced to finance their

long term assets (principally mortgages) with shorter term liabilities. This kind of situation creates a significant strain on the performance of the trust and loan companies' operations. As long as trust and loan companies are tied to mortgage lending on the uses side and to GIC's on the sources side this situation will exist in periods of rising interest rates. The effect will be felt even more by the mortgage loan companies, the trust companies at least enjoying the marginal revenue contribution of their E T & A business and of their real estate brokerage.

E T & A, though a contribution, itself is plagued with the problems outlined earlier and is not expected to benefit significantly from improvements in overall economic conditions. The real estate brokerage business appears to have been a great boost to trust companies' profits and seems to be the only area benefitting nominally from inflation. Construction and housing prices have risen with inflation; house prices, for example, have increased drastically so that commission revenues have jumped equally dramatically without a corresponding rise in overhead costs. This activity, however, is not the real business purpose of trust and loan companies and still amounts to a small percentage of revenues; it may therefore be said that inflationary conditions have adversely affected the operation of trust and loan companies and that continued limitations on the legal leverage ratio will mean a deteriorating profitability picture for trust and loan companies. On the other hand, as is demonstrated below, the chartered banks' operations are largely shielded from inflation due to their ability to immediately transmit higher borrowing costs to a large part of their asset portfolio.

C. Comparison Between Trust and Loan Companies and Chartered Banks Profitability

We have examined the respective returns on equity for trust and loan companies combined and for chartered banks for the period following the 1967 Bank Act to the present. The return on equity for trust and loan companies includes all their E T & A, financial intermediation, real estate brokerage and other activities. The figures obtained from the chartered banks reflect their consolidated operations as available from the Bank of Canada's statistics. Return on equity figures for the banks are calculated in a manner which provides conservative estimates comparable with the results computed for the trust & loan companies.[1]

In all cases, (See Table XXIII) banks have outperformed trust and loan companies by a significant margin realizing a substantial gain since the 1967 Bank Act. Using the Bank of Canada's statistics, the chartered banks' performance has consistently been about 30 to 60% higher than that of the trust and loan companies. While the banks' rate of return rose above 10% in 1968 and reached a high of 14.88% in 1972, trust and loan companies have experienced a more moderate increase only reaching the 10% mark in 1972 and 1973 and most often remaining in the 6-9% range. We also notice the important step increment in profitability occurring immediately after the amendments to the Bank act legislated in 1967.

The chartered banks' return is well above the half-way point of the industrial average for those years, the trust and loan companies are distinctly in the lower half; consequently the latter's relative performance does not appear attractive and raising additional capital can therefore be difficult and expensive.

Several reasons may be given to explain the relative profitability performance of banks and trust and loan companies. Firstly, the banks have a great deal more flexibility in the scope of their lending; they may shift their assets into commercial or consumer loans, mortgages and securities to accomodate themselves to opportunities or constraints. For example, when spreads change relatively for consumer, commercial or mortgage loans, they may take advantage of their opportunities whereas trust and loan companies do not have the same flexibility.

(1) See Methodology & Statistical Sources—Appendix I

Secondly, banks still currently have a higher effective leverage than the trust and loan companies, even though trust and loan companies have been progressing towards a 25:1 leverage resulting in greater profitability. The banks no doubt have more stringent and costlier liquidity requirements but these requirements do not vitiate the effect of the powerful leverage differential. It should be pointed out nevertheless that the gradual increase in trust and loan companies leverage from about 15:1 to slightly over 20:1 enabled them to compensate for the financial cost squeeze occurring over the same period. Without the gradual increase in leverage, trust and loan companies' operations would have fared much worse.

Thirdly, a rise in the prime rate may have a much more favourable effect on the chartered banks than on the trust and loan companies. This is principally due to the chartered banks' ability to immediately pass on the increased costs to their customers: a far larger proportion of the banks' assets are in the form of demand loans where rate increases can be simultaneously moved onto the borrower. In the case of trust and loan companies the interest revenue on assets is largely fixed to maturity and consequently the flexibility of raising revenues concurrently with increases in borrowing costs is denied to trust and loan companies.

On the liability side, chartered banks have a large pool of non-interest bearing deposits, which as interest rates rise, become very important in keeping the cost of money down. Banks also have fairly large amounts of term deposits on which the increase in interest rates only takes place over a period of time as the term deposits mature. Trust and loan companies benefit from the same advantage to the extent that they borrow through term instruments and consequently benefit from the delayed adjustment to interest rate rises.

Trust and loan companies do not benefit from a large interest free liability base and consequently have a higher average cost of money than the chartered banks. Furthermore, they do not have the flexibility on the asset side which permits them to move their revenues up by increasing their customers' borrowing rate when a rise in the prime rate occurs. There is no question therefore that the chartered banks are protected substantially more than trust and loan companies from inflationary trends and increases in interest rates.

Fourthly, the chartered banks' entry into the long term deposit market may have caused some changes in the overall capital markets, making it both more difficult and more expensive for trust and loan companies to find GIC money. As indicated in our earlier discussion on flexibility, banks have been authorized by their statutes to make consumer, commercial and mortgage loans as well as a whole range of investments. The net interest spread on loans margins having become more favourable than that on mortgages enabled chartered banks, while maintaining their spread, to increase the interest paid on term deposits and compete aggressively for term deposit money. Though their cost of money rose at the margin their average cost still remained well below that of trust and loan companies. The banks' aggressive bidding for term deposits not only increased the cost of these funds but also restricted the availability of mortgage money to other financial intermediaries.

D. Profitability, Growth and Capital Funding

An adequate return on equity is essential to an industry needing capital for expansion. Certainly, for the trust and loan companies, demand for their intermediation services and primarily for mortgages has been very good and the industry has been meeting this demand to the extent of its powers despite a profit squeeze. Rising interest costs on the sources of funds have been the principal damaging effect on the trust and loan companies.

Unless the current inflationary environment is changed substantially trust and loan companies will be plagued with the following dilemma: demand for mortgages will increase at the current

rates; trust and loan companies' activities should therefore grow to meet their demand. Recent legislative changes in leverage will help somewhat, but reduced internally generated retained earnings will not be sufficient to meet the necessary expansion. If subordinated notes or additional equity are raised it will be on disadvantageous terms since the profit performance and the return on equity have been less than glamorous over the past decade.

The irony therefore is that in times when expansion is socially justifiable and badly needed, trust and loan companies, for the reasons mentioned earlier, may suffer a reduction in profits which will make it both expensive for them to raise capital and will render trust and loan company shares unattractive to investors.

E. Profitability and Branch Expansion

One of the superficially attractive arguments for the diffusion of financial services through the chartered banks is their thesis that, by reason of their widespread branch network, they should be entitled to expand their activities in any direction, because this will produce a social benefit by fully servicing the Canadian public. This argument has been used with regard to leasing, the Registered Home Owner Savings Plan (R.H.O.S.P.), selling of securities and various other activities.We discuss later in this submission whether or not the specific activities are proper functions for chartered banks, and will limit ourselves here to the argument of expediency. It is evident that this argument pushed to the extreme would result in the banks' having a monopoly of financial services. The granting of additional powers to sell new financial services for the sole reason of their branch coverage only serves to continue to erode the financial base of the non-bank financial intermediaries. The latter intermediaries must continue to have the profitable activities available to them to provide them with incentives to expand their branch network. If the banks are permitted to have all the new services given to them on the grounds of their present locational advantage, then the present imbalance between the branch systems of chartered banks and all other financial intermediaries will be perpetuated. It is therefore interesting to note that in the past, banks have been granted the right to undertake non-bank operations for reasons of expediency alone. We have already witnessed this and a continuation of this approach will accentuate the imbalance within the financial system.

F. Conclusions

In summary, we see that profitability an performance of the trust and loan companies has suffered from the industry's inherent inability to diversify its lending activities. Profits have been maintained mostly through changes in legislation allowing higher effective leverage over the past decade. E T & A business has suffered from increasing complexity and costs with only the real estate brokerage business temporarily providing some compensation.

One of the main problems is the aggressive incursion of chartered banks into the term deposit market. We do not consider this to be a banking function and we also believe that it gives rise to social costs exceeding the benefits.[(1)] If the banks are to remain in this market over the long term, the effect on trust and loan companies will be damaging and the overall economic and social repercussions on a constrained mortgage market will also be costly.

In the short term we do not anticipate that interest rates will drop sharply and consequently the trust and loan industry should brace itself for a continued profit squeeze as long as the cost of their sources of funds is dictated by the chartered banks' needs and opportunities. Finally, the increasing competition for capital, originating both from the public and private sectors, will continue to work against institutions whose profitability is hampered by inflationary conditions and lack of flexibility. Capital may therefore be restricted for intermediaries such as trust and loan companies but more available to chartered banks, resulting in a misallocation of capital resources with respect to social needs.

(1) See Section IV Chapter 3, Long Term Debt Instruments & the Canadian Financial Institutions

TABLE XX
TRUST COMPANIES DISTRIBUTION OF WAGE EXPENDITURES AS A PERCENTAGE OF GROSS INCOME NET OF INTEREST COSTS

	1967	1968	1969	1970	1971	1972	1973	1974
Interest Revenue: ($)	257.3	302.4	337.5	479.5	538.7	619.3	760.8	1017.0
Dividends: ($)	4.1	5.1	6.0	6.5	6.3	8.3	9.9	12.3
Less Interest Cost ($)	189.9	234.5	269.3	395.3	416.3	467.9	598.4	903.3
Net Financial Income ($)	71.5	73.0	73.2	90.7	127.7	159.7	172.3	126.0
Plus Gross Fee ($)	80.5	91.4	94.2	98.6	104.6	116.5	123.0	137.6
Plus Net Real Estate Commissions ($)				8.5	12.4	21.5	36.9	47.4
Plus Other Revenue ($)	9.9	8.5	14.4	9.0	11.2	13.7	21.1	28.8
Gross Income Net of Interest Costs ($)	169.9	172.9	181.8	207.0	255.9	311.4	353.3	339.8
Salaries ($)	N/A	N/A	79.7	86.7	97.2	118.8	131.8	156.4
Wage Expenditures as a Percentage of Gross Income Net of Interest Costs (%)	—	—	44.0	41.9	38.0	38.6	37.3	46.0

Source:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006.

TABLE XXI

PROFITABILITY OF TRUST COMPANIES

Year	Total Assets	Shareholders Equity	Operating Income Before Taxes	Operating Income After Taxes	Taxes Paid	After Tax Return on Assets	Return on Equity
1967	4,229.2	345,480	34,910	21,820	13,090	0.52	6.32
1968	4,721.2	367,950	37,282	21,124	16,158	0.45	5.74
1969	4,721.2	406,439	45,808	25,966	19,842	0.47	6.39
1970	6,352.7	423,203	49,248	27,637	21,611	0.44	6.53
1971	7,137.7	454,254	58,000	47,151	40,849	0.66	10.38
1972	8.157.7	515,767	105,645	59.196	46,449	0.73	11.48
1973	9,756.8	562,719	117,570	64,128	53,442	0.66	11.40
1974	11,878.2	613,346	88,199	48,638	39,561	0.41	7.93

PROFITABILITY OF MORTGAGE COMPANIES

Year	Total Assets	Shareholders Equity	Operating Income Before Taxes	Operating Income After Taxes	Taxes Paid	After Tax Return on Assets	Return on Equity
1967	2,686.2	314,768	36,991	23,942	13,049	1.04	8.88
1968	2,877.2	342,761	39,465	23,361	16,104	0.81	6.86
1969	3.168.9	406,099	42,325	23,715	18,610	0.75	5.84
1970	3,557.3	446,884	40,548	23,864	16,684	0.67	5.34
1971	2,953.1	490,703	63,090	38,654	24,436	0.98	7.88
1972	4,484.1	506,213	74,858	46,375	28,483	1.03	9.16
1973	5,465.4	540,307	85,027	51,033	33,994	0.93	9.45
1974	6,439.4	568,632	78,292	49,152	29,140	0.76	8.64

PROFITABILITY OF TRUST & MORTGAGE COMPANIES COMBINED

Year	Total Assets	Shareholders Equity	Operating Income Before Taxes	Operating Income After Taxes	Taxes Paid	After Tax Return on Assets	Return on Equity
1967	6,915.4	660,243	71,901	45,762	26,139	0.72	7.54
1968	7,598.4	708,711	76,747	44,485	32,262	0.59	6.28
1969	8,662.1	812,538	88,133	49,681	38,452	0.57	6.11
1970	9,910.0	870,087	89,796	51,501	38,295	0.52	5.92
1971	11,090.8	944,957	121,090	85,805	65,285	0.77	9.08
1972	12,641.8	1,021,980	180,503	105,571	74,932	0.84	10.33
1973	15,222.2	1,103,026	202,597	115,161	87,436	0.76	10.44
1974	18,37.6	1,181,978	166,491	97,790	68,701	0.53	8.27

SOURCE:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006

TABLE XXII

FINANCIAL PERFORMANCE SPREADS

1. TRUST COMPANIES

Year	Average Financial Assets ($000,000)	Average Financial Liabilities	Financial Revenue	Interest Expense	Avge. Return on Financial Assets (%)	Avge. Cost of Financial Liabilities	Spread
1967	4,109,396	3,783,944	261,340	189,884	6.36	5.02	1.34
1968	4,595,641	4,218,830	307,472	234,464	6.69	5.56	1.13
1969	5,347,541	4,926,134	343,526	269,296	6.42	5.47	0.95
1970	6,168,702	5,723,457	485,988	395,252	7.88	6.91	0.97
1971	6,946,921	6,489,652	545,009	415,889	7.85	6.41	1.44
1972	7,967,236	7,405,428	628,052	467,857	7.88	6.32	1.56
1973	9,545,201	8,923,103	778,311	598,369	8.15	6.71	1.44
1974	11,603,884	10,913,445	1,038,940	863,238	8.90	7.91	0.99
2. MORTGAGE COMPANIES							
1967	2,583,577	2,082,883	179,607	117,826	6.95	5.66	1.29
1968	2,767,491	2,279,938	198,435	130,920	7.17	5.70	1.43
1969	3,054,350	2,467,852	225,194	145,277	7.37	5.89	1.48
1970	3,438,650	2,809,507	267,253	186,559	7.77	6.64	1.13
1971	3,818,176	3,137,893	312,049	215,645	8.17	6.87	1.30
1972	4,332,156	3,549,435	361,084	246,977	8.33	6.96	1.37
1973	5,318,832	4,102,137	451,949	316,864	8.50	7.72	0.78
1974	6,282,205	4,938,885	571,929	432,147	9.10	8.75	0.35
3. TRUST & MORTGAGE COMPANIES COMBINED							
1967	6,692,973	5,866,827	440,947	307,710	6.59	5.24	1.35
1968	7,363,132	6,498,768	505,907	365,384	6.87	5.62	1.25
1969	8,401,891	7,393,986	568,720	414,573	6.77	5.61	1.16
1970	9,607,352	8,532,964	753,241	581,811	7.84	6.82	1.02
1971	10,765,097	9,627,545	857,058	631,534	7.96	6.56	1.40
1972	12,299,392	10,954,863	989,136	714,834	8.04	6.53	1.51
1973	14,364,033	13,025,240	1,230,260	915,233	8.28	7.03	1.25
1974	17,886,088	15,852,330	1,604,919	1,295,385	8.97	8.17	0.80

SOURCE:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006

TABLE XXIII
PERFORMANCE
TRUST AND MORTGAGE COMPANIES[1]

(%)

	1967	1968	1969	1970	1971	1972	1973	1974
After Tax Return on Average Total Assets:	0.66	0.61	0.61	0.55	0.81	0.88	0.82	0.58
Net Interest Rate Spread:	1.35	1.25	1.16	1.02	1.40	1.51	1.25	.80
After Tax Return on Average Equity	7.06	6.49	6.53	6.12	9.45	10.73	10.83	8.55

CHARTERED BANKS[1]

	1967	1968	1969	1970	1971	1972	1973	1974
After tax return on average equity	9.75	13.76	12.18	11.72	12.15	14.04	14.88	14.37

Sources:
Statistics Canada, **Financial Institutions: Financial Statistics,** Cat. No. 61-006.

Bank of Canada, **Review.**

[1] For further details on methodology and sources, see "Methodology and Statistical Sources" - Appendix I.

III INTERMEDIATION AND THE NATURE OF BANKING

1. INTRODUCTION:

A. Purpose:

The main objective of a financial system is to provide the economy with its monetary and intermediary function. The economy itself operates through a complex interaction with social and political needs. As society has developed, its economic needs have evolved and the financial system with its component institutions has had to change to accommodate or anticipate these needs.

The purpose of examining the relationship between trust and loan company operations, financial intermediation and the nature of banking is to gain a perspective into the dynamics of the existing financial system as well as to formulate improvements to the structure. In the process of our analysis, we first concentrate on the existing regulations which control the major set of financial institutions in Canada. Having considered previously the inter-relationship of all financial institutions in the Canadian capital market, we now concentrate on the chartered banks and the trust and loan companies in isolation for the sake of clarity, and because among all financial institutions the banks' operations are most relevant to our analysis and assessment of present and future problems in relationship to the upcoming Bank Act Review.

To gain a better perspective of change and impending modification to our financial system we review in the second part of this Section amendments to banking legislation, both in Canada and in the U.S. The U.S. experience is particularly interesting since that country has already experienced some of the changes which may be suggested in the forthcoming revision of the Canadian Bank Act.

B. Fundamentals:

In the third part of this Section we revert to analyzing the basic properties of the monetary and banking function within an economy. This process enables us to develop a fundamental model of a financial system which relies on the monetary function of banking at its base. Much of the evolution of our financial system has been a result of reaction rather than action and of osmosis than consciously applied logic; consequently our system has departed from basic principles and from the fundamentals needed in a monetary economy. It is both timely and essential to investigate and restate these principles and fundamentals and from them build a simple conceptual framework for the financial system.

In our sophisticated world, it is increasingly important to retain simple and meaningful relationships between instititutions. If we can construct a simple model of the banking function based on fundamental relationships and compare this model to the existing situation we shall se not only how far we have deviated from fundamentals but also what is needed to bring us back.

In the last part of this Section we examine the nature of the current operations of trust and loan companies and of chartered banks to determine how closely these activities relate firstly to the spirit or intent of the statutes and secondly to our basic needs as determined by a fundamental definition of the nature of banking. From this analysis we can suggest amendments to the Bank Act which are logical and necessary to provide sound and efficient financial systems in the future.

C. Generalization and Specialization:

There are two main issues related to identification of the true nature of the banking function within an economic and financial system. The first relates to a choice between generalization and specialization of financial intermediaries, markets or instruments; the second is monetary control.

Generalization implies an expansion of the range of activities of institutions from their present level. It implies open competition in any new market, and will tend in consequence to favour the chartered banks whose present size and market power overshadow those of other institutions. In Canada, generalization will lead to only one result: an increased concentration of power. One of the necessary ingredients to establish equal as opposed to open competition is the knowledge that none of the participants possesses an insurmountable advantage over the other.

The alternative of specialization implies defining the relationship between markets, competitors and participants. Some specialization exists currently, and an expansion of the concept can be used effectively to channel financial resources for socio-economic purposes, for competition or to expand new markets.

Thus, specialization offers advantages, not only as a control mechanism in a system comprising competitors of different size and strength, but also to further the objectives of general economic welfare and efficiency. Specialization lends itself better than generalization to the channelling of financial assets through different institutions to specific markets, and could thereby assist the expression of economic policy as well as that of traditional monetary policy.

A defined level of specialization is feasible through the definition of institutional activities in both the sources and uses of funds. The desirable level of specialization can only be determined satisfactorily when we have clearly identified the true nature of banking within our financial system.

D. Monetary Control:

The second issue related to the nature of banking is that of the extent of control of the money supply. Since banking is a monetary function, policy, to be effective, must pertain to banking. It is therefore essential to have a proper understanding of the nature of banking and its relationship to financial intermediation. A perspective of the nature of banking is also necessary in order to establish a workable and structured relationship among financial institutions that are disparate in size, power and profile.

Policy places the emphasis on controlling the monetary variables, not legislating financial institutions. Thus, since central bank action aims to act directly on the money stocks and flows with the purpose of affecting economic circumstances indirectly, the most effective type of monetary policy is the kind which is targeted directly on institutions handling monetary instruments oniy. For the sake of effective monetary policy it is considered more efficient to have immediate and direct control over narrowly defined monetary assets contained within an accessible set of financial institutions.

Lastly, it is critical for the central bank administration to control the proper variables through which monetary policy can best be implemented. To do this one must have an implicit knowledge of the nature of banking, and its relationship to the financial system and all other financial intermediaries.

F. Financial Intermediaries Act

A school of thought believes, as did the Porter Commission, that the various deposit-taking institutions in the Canadian financial system should all operate under powers granted by a ''Financial Intermediaries Act'', which would:—

1. Provide open competition, with subsequent public benefit.
2. Simplify problems of regulation of the financial system in the national and public interest.
3. Provide the basis for more effective monetary policy by extending the Bank of Canada's control to institutions not presently covered.

We suggest that the analysis of financial functions performed by various institutions that is outlined in this submission supports the contrary view. If competition is to be encouraged in the public interest, which we suggest should be a prime objective of any legislative amendment, then the competition must be equal, which is not necessarily the same as open. We shall be referring in most sections of the brief to the chartered banks' dominant position on the Canadian financial scene, which in any area of open competition gives them an overpowering advantage. The previous arguments for specialization, as opposed to generalization and against standardization and extension within the following section on reserves disclose fully the trust and loan industry's position on the effectiveness of monetary policy and the necessity of central control.

The jurisdictional problems associated with the imposition of a central control over all financial intermediaries in a Federal system is sufficiently obvious that it need not be covered here.

G. Defining and Closing Gaps:

In this submission, we have concentrated on defining the gap between the existing situation and what we contend would be an improved system. This gap can be closed by legal and statutory amendments within the reach of our political system. A pragmatic view of our world suggests that we make certain critical assumptions and accept certain premises, among which is that the existing structure of our financial system is workable but can be made more efficient. We take into account the magnitude of difference in power and market exposure which exists in our present system between market participants, realizing that changes might be arduous and lengthy though necessary. Thus, though generalization might appear theoretically valid in practice it would be damaging, given the current structure of our financial system. Lastly, recommendations are based on the guiding principle of pragmatic realism which dictates that we should recommend only the things we can do, and those things should be done first which can be done now.

2. TRUST AND LOAN COMPANIES AND CHARTERED BANKS: OBJECTS AND POWERS

A. Introduction:

An investigation into the nature of banking and financial intermediation necessarily brings us to the statutory constraints operating on the financial system and its participants. Legislation of the financial system in Canada is done on a periodic basis with most amendments corresponding to the current or anticipated socio-economic needs. We felt it was important to review, not only the current legislation for trust and loan companies and for chartered banks, but also the proposed amendments to the legislation. The latter provide us with a good indication of trends and pressures for change to the financial system and its participants. We also felt that, because the chartered banks play such an active role in our economy, it was essential to examine their statutes and operations to contrast and compare them with those of the trust and loan companies. Lastly, since Canadian financial markets have developed in close rapport with the U.S. markets even though the systems have major differences, we felt it would be enlightening to examine banking statutes and proposed amendments in the U.S. as well as in Canada.

B. Statutory Objects and Powers of Trust and Loan Companies

Trust company legislation, while not uniform throughout Canada, is sufficiently similar to permit an examination of objects and powers to be made without detailed reference to each of the provincial and federal acts.

From the legislation it is immediately clear that a distinction has been made between the trust company's original "fiduciary services function" on the one hand, and its later "financial intermediary function", on the other. This categorization is adopted here. We feel the best concise summary of the fiduciary services function is contained in a restatement drafted by the 1975 Report of the Ontario Select Committee on Company Law on Loan and Trust Corporations.

i. Fiduciary Services Function

(Proposed New Section Stating Objects of Trust Companies: 84. (1))

"Subject to sections 87, 88 and 89 of the Ontario Loan & Trust Corporations Act and to any provisions of this Act respecting the investment of moneys received for guaranteed investment or as deposits, a provincial trust company may and any other registered trust company that has capacity to do so may:

(a) take, receive and hold all estates and real and personal property that may be granted, committed, transferred or conveyed to the company with its consent, upon any trust or trusts whatsoever not contrary to law, at any time or times, by any persons or persons, body or bodies corporate, or by any court of competent jurisdiction;

(b) take and receive as trustee or as bailee, upon such terms and for such remuneration as are agreed upon, deeds, wills, policies of insurance, bonds, debentures or other valuable papers or securities for money, jewelry, plate or other chattel property of any kind, and to guarantee the safe keeping of the same;

(c) receive and store for safe keeping all kinds of securities and personal property and rent spaces or compartments for the storage of securities or personal property and enter into contracts for regulating the terms and conditions upon which such business is to be carried on;

(d) act generally as attorney or agent for the transaction of business, the sale or purchase of any real or personal property, the winding up of estates and partnerships, the receipt or collection of loans, rents, interest, dividends, debts, mortgages, debentures, bonds, bills, notes, coupons and other securities for money;

(e) act as investing and managing agent of estates, properties and trusts for and on behalf of executors, administrators and trustees or other persons;

(f) act as transfer agent, registrar, authenticating agent, disbursing agent or fiscal agent for any person, organization, association, trust, body corporate, municipality or government, and to receive, invest and manage any sinking fund on such terms as are agreed upon;

(g) accept and execute the offices of executor, administrator, trustee, indenture trustee, receiver, liquidator, assignee, bailee, custodian, trustee in bankruptcy, trustee for the benefit of creditors, guardian of any minor's estate, committee of any mentally incompetent person's estate, arbitrator, valuator or appraiser, and perform the duties of such offices or trusts as fully and completely as any person so appointed;

(h) invest any trust money in the hands of the company in any securities in which private trustees may by law invest trust money;

(i) charge, collect and receive all proper remuneration, legal, usual and customary costs, charges and expenses for all such services, duties and trusts."

ii Financial Intermediary Function

This field of trust company activity is best considered according to the sources (liabilities) and uses (assets) of funds involved in this aspect of a trust company's operation. We use the Ontario Loan and Trust Corporation Act as a model for this presentation. Federal and other provincial legislation is very similar.

a) Sources (Liabilities)

Apart from capital, trust companies have two sources of funds available to them: deposits and borrowed funds.

With respect to deposits S.88(1) of the Ontario Act states that, "subject to S.153, a provincial trust company and any other registered trust company that has capacity to do so may receive

deposits of money repayable upon demand or after notice... " However, S.88(2) specifies that any deposits received in the above manner are deemed to be trust moneys in that they are held by the trust company as trustee for the depositors and the trust company guarantees repayment of these deposits. Added to the statutory definition of "deposits" are the restrictions placed on such funds. With respect to the interest payable on deposits, S.88 specifies that on demand and notice deposits a trust company may pay interest "at such rates and on such terms as the company may from time to time establish". Section 93 stipulates that the liquidity requirements on deposits in trust companies must be an aggregate of at least 20 percent of the amount of deposits and of funds received for guaranteed investment coming due in less than 100 days. It further specifies the form of these liquidity requirements.[1]

Sub-section 93(2) prescribes the composition of these reserves.

With respect to borrowing, although S.87(1) prohibits trust companies from borrowing by issuing debentures, S.87(1) sanctions trust companies borrowing on the security of "all or any of the real or personal property, present or future, of the company other than property deemed by this act to be held by the company as trustee or received for investment under section 88 and 89..." Section 89 embodies the enabling language for guaranteed investment certificates. Sub-section 89(1) specifies that a trust company may "receive money for the purpose of its being invested by the company and may guarantee the repayment of money so received..." Sub-section 89(2) elaborates on Sub-section 89(1) by stipulating that such a guarantee is not a debenture and the money shall not be deemed to be money borrowed by the company by issuing debentures but to be money received in trust. The payment of interest on guaranteed investment certificates is to be determined at such rate "as is agreed upon on fixed days" is specified in Sub-section 89(1).

Section 90 limits the total of the moneys that can be accepted as deposits under section 88 or borrowed under sections 87 and 89. It stipulates that this total, "shall not at any time exceed an amount equal to twelve and one-half times the aggregate of its (i.e. a registered trust company's) unimpaired capital and reserve". This rigid limit is amended somewhat by the powers section 90 also ascribes to the Lieutenant Governor-in-Council. These powers include the ability to: a) increase the total amount that may be received by a trust company to any amount not exceeding twenty times the aggregate of such capital and reserve; and b) to prescribe the portion of the total amount that may be so received or borrowed by such company that may be received by way of deposits.

Even more recent modifications allow trust and loan companies, to include subordinated notes in their capital base subject to limits set from time to time by the Registrar thereby increasing the leverage potential and exceeding a twenty times multiple.

b) Uses (Assets)

In this context loans and investments for trust companies are strictly regulated. In Ontario, the approved list is contained in S.153 for Guaranteed Funds Account.

By virtue of S.153(4) a registered trust company may lend its own funds and moneys received for guaranteed investment, or as deposits, on the security of mortgages and assignments of life insurance policies, government bonds, bonds secured by trust deed, conventional mortgages to 75% of value, N.H.A. mortgages, insured mortgages, the bonds, debentures, or other securities of the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, or the government of any country in which the corporation is carrying on business or a province or state; federal subsidy bonds, provincial subsidy bonds,

(1) For specific details, see section entitled: **"Trust and Loan Companies and Reserve Requirements".**

transportation equipment certificates, the debentures, preferred shares and common shares of any company meeting the requirements of Ss.150(1) (k)-(m); and finally, the guaranteed investment certificates of trust companies.

The powers and restrictions of trust companies with respect to investments are governed by Ss.155, 153(1) (2) and (3) and 157.

The above specific investment powers are restricted somewhat by S.153(1) which stipulates that at least 50% of a trust company's funds received for guaranteed investment (or as deposits) must at all times be invested in or loaned upon securities authorized by S.26 of the Trustee Act, R.S.O. 1970, C.470.

Furthermore, by S.153(2) the amount of investment in real estate is generally restricted to 10% of the book value of the total assets of a trust company's funds.

Still further restrictions on the investment of trust company funds and money received for guaranteed investment (or as deposits) per sections 88 and 89 are imposed by S.157(1). Sub-clause 157(1) (a) (i) limits the investment in any one security to 15% of a trust company's own paid in capital stock and reserve funds and clause 157(1) (d) prohibits investment where the effect would be that a trust company would then hold more than 20% of the stock or more than 20% of the debentures of any one corporation, company or bank, (other than special purpose companies as defined by the Act.)

Section 163 imposes additional restrictions on investments to avoid conflicts of interest. These are over and above the restrictions on loans already considered under S.153. By section 163 a trust company is prohibited from knowingly making an investment in:

— a company that is a substantial shareholder of the trust company;
— a company in which an individual or corporation who is a substantial shareholder of the trust company has a significant interest;
— or in a company in which a director of officer of the trust company (or a spouse or child of such a director or officer) has a significant interest.

Finally, with respect to investments as well as loans, S.154 — or the "Basket Clause" — is important in that it broadens the scope of the trust companies' use of funds. It generally allows any investments and loans not authorized by section 153, but not prohibited by any other section, to be made. The effect of this is to allow personal loans, for instance, to be made. By virtue of sub-section S.154 (b) however, the total book value of the investments and loans made under S.154 are limited to not more than the larger of 15% of a trust company's unimpaired capital and reserves or such percentage as the Registrar of trust companies may approve. This percentage, subject to the Registrar's approval, is itself restricted to a maximum of 7% of the aggregate of the unimpaired capital and reserve of the company and the moneys held by it for guaranteed investment or as deposits.

iii. Summary

The major difference between the financial intermediary function and the trustee function is that in the trustee business the trust company receives compensation or acts on a fee for service basis, while in the intermediary area it is acting as a principal with its own funds and deposits at risk. The financial intermediary function is understood to involve the companies "receiving" and "borrowing" deposits from the public in the form of demand deposits, notice deposits and guaranteed investment certificates. The proceeds are primarily invested in first mortgages, securities and other loans. As previously explained, the major regulations on both the sources and uses side of the financial intermediary function are quite explicit.

Not only is the financial intermediation aspect strictly controlled by the statutes and regulations, but all aspects of trust business are overshadowed by the constraints of trusteeship. Thus, the concept of the "prudent man", the responsibility as trustee and very strict regulations regarding conflict of interest have ruled the E T & A functions and have noticeably pervaded the intermediary function. This provides the trust and loan companies with a significantly different regulatory background from that of the chartered banks.

C. Statutory Objects and Powers of Chartered Banks

i. Canada

In Canada, the Bank Act, R.S.C. 1970, C.B01, offers no explicit definition of banking. Section 75(1) (e) merely states that, "The bank may engage in and carry on such business generally as appertains to the business of banking".

The Act provides a statutory definition of sorts of the business of banking by authorizing a bank to do specified classes of acts, and prohibiting it from doing certain other specified classes of acts. This is clearly seen by referring to the sections of the Act which deal, firstly, with liabilities (sources of funds) and, secondly, with assets (uses of funds).

a) Sources (liabilities)

The liability side of any definition of "the business of banking" primarily consists of the receipt of deposits from its customers, the payment of the interest on such deposits, the payment of customers' cheques and the issuing of bank debentures. Section 95 prescribes the deposit-taking powers and chequing obligations of a bank. By S.95 (a) a bank may "receive deposits from any person whomsoever, whatever his status or condition in life..."

By S.95 (b) the bank may "from time to time pay any or all of the principal thereof and any or all of the interest thereon to or to the order of such person". Section 91 prescribes a bank's powers with respect to the interest payable on deposit accounts. It states that, "The bank may pay any rate of interest on a debt payable by the bank..."

Section 77 defines bank powers to borrow by issuing debentures. Sub-section 77(2) states, "the bank may borrow money by the issue of bank debentures", while sub-section 77(3) stipulates that these debentures must have a stated maturity of at least five years. These debentures are an addition to the permanent capital of the bank, which also includes its paid in capital, reserves and retained earnings.

While the above sections illustrate the distinction between bank liabilities arising from the deposit-taking function and those arising from borrowing by debentures, section 72 must also be considered to the extent that it affects the deposit-taking function. This section stipulates that cash reserves must be held against all deposits defined by S.95. Sub-section 72(1) states that "the bank should maintain a cash reserve in the form of notes and deposits in Canadian currency with the bank of Canada". Except for sub-section 72(4), the remaining sub-sections of S.72 prescribe the mechanism for determining the amount of these reserves. S.72 (1) (a) prescribes the minimum cash reserve percentage of demand deposits of 12%. By S.72 (1) (b) the required percentage on notice deposits shall not be less than 4%. Sub-section 72(4), provides for the maintenance of a "secondary reserve", in addition to its cash reserve, which may be required by the Bank of Canada. In summary, from the point of view of sources, "the business of banking" involves three functions:

1) The taking of deposits and all the rights and obligations associated with this function, and
2) borrowing by debentures. (It may be worthwhile noting here that no constraints are placed on the maturity of the deposits taken) and
3) use of shareholders capital reserves and retained earnings.

b) Uses (Assets)

The uses side of the "business of banking" includes loans, advances and investments. Loans and advances are dealt with in Sections 75, 76, 86 and 88.

—Loans and Advances:

The power to make commercial and consumer loans and advances, with and without security, is clearly prescribed in the Act. Section 75, in particular, specifies various kinds of security upon which a bank may lend money, and other kinds of security upon which it may not do so.

To these provisions of S.75 for lending and security, S.86 adds warehouse receipts and bills of lading. Of great practical importance is S.88, sub-section (1) which authorizes banks to lend against goods in the process of manufacture and distribution.

However, over and above these provisions for secured loans is clause (d) of S.75 (1) which provides that a bank may "lend money without security", that is, upon the personal obligation of the borrower without security for that obligation. This constitutes an important difference from trust companies' powers. The provisions prohibiting loans made on specific kinds of security are stated in several sections.

— Investments:

Three areas of activity fall within the investment function of banks: discounting commercial paper for its customers, dealing in foreign exchange and in gold and silver coin and bullion, and investing in the securities of Canadian and foreign corporations.

Normally, discounting is a sale of a claim against a third party (that is, where the claim is embodied in a negotiable instrument of which ownership passes to the buyer on purchase), with an implied guarantee, on the seller's part, of the payment of the claim at maturity. This form of dealing in bills is covered by the comprehensive language of S.75 (1)(b).

Limitations upon bank ownership of shares of other companies are imposed by S.76. Generally, in the case of Canadian corporations except trust or loan companies, where a bank has not paid over $5,000,000 for shares with voting rights, a limit of 50% of the total voting rights is set and in all other cases the limit is 10% of the voting rights. A 10% limit is also applied whenever the corporation is a trust or loan corporation as defined in sub-section (9)(d). The provisions of sub-section (2) impose similar restrictions upon the ownership of shares in a foreign corporation. There is also a general exception to the application of these limits in the case of shares of "bank service corporations" as defined in Sub-section (9)(s). By this sub-section, a "bank service corporation" means a corporation owning or leasing real or immoveable property for the actual use and occupation of the bank and the management of its business, (ii) a corporation owning shares of the capital stock referred to in sub-paragraph (i), (iii) a corporation engaging in the business of providing a service incidental or ancillary to, or used in the carrying on of, the business of the bank or of a corporation referred to in sub-paragraph (i) (a) (ii), and (iv) a corporation owning shares of the capital stock of a corporation referred to in sub-paragraph (iii). A further limitation upon bank ownership of shares of other companies is imposed by S.75 (2)(b) which prohibits a bank from "directly or indirectly dealing in goods, wares and merchandise or engaging in any trade or business".

In summary, from the point of view of assets, the statutorily defined "business of banking" includes loans and advances, on the one hand, and investments on the other. Loans and advances can be either secured or unsecured and can also be granted for either commercial or consumer use. The discounting of commercial paper and foreign exchange transactions are clearly within "the business of banking". However, the extent to which direct investments in shares of companies are within "the business of banking" is severely limited in law but not in practice.

Problems of interpretation have inevitably arisen in instances which require an interpretation of the words ``incidental`` or ``ancillary to``. Here the statutes remain perhaps purposely vague, and the lack of precise definition in this clause has given chartered banks a free hand for expansion. An explicit limitation, however, exists on the ownership of goods and wares and the direct undertaking of trade or commerce.

ii. The United States

In the United States, the Bank Holding Company Act, 70 Stat. 133, was passed in 1956. The purpose and effect of the Act was to establish a public policy of separating commercial banking from non-banking enterprises. Since the passage of the 1970 amendments, the Federal Reserve Board's activity in administering the amended Act has been confined to two areas: deciding what activities are not ``closely related to banking``, and approving or rejecting applications by bank holding companies to take over other banks. Examining the Board's post-1970 rulings and regulations provides an insight into the Federal Reserve Board's definition of banking.

In the area of related activities, the Federal Reserve Board had approved ten. These are:

1. Making loans directly or through a subsidiary for the accounts of others, such as mortgage companies, finance companies, credit card companies, or factoring companies.
2. Operating as an industrial bank or industrial loan company.
3. Servicing loans.
4. Conducting fiduciary activities.
5. Acting as investment or financial advisor, including (a) serving as an advisory company to Real Estate Investment Trusts; (b) serving as an investment advisor to mutual funds; (c) providing investment advice to other persons; (d) providing general economic, statistical forecasting and industry, studies and information; and (e) providing financial advice to state and local governments concerning the issuance of securities.
6. Leasing personal and real property, under certain limitations.
7. Making equity investments in corporations that promote the community welfare.
8. Providing bookkeeping and data processing services, under certain limitations.
9. Operating insurance agencies, under certain limitations.
10. Operating an insurance underwriting company limited to writing declining term credit life, health and accident insurance in connection with the granting of credit.

The Federal Reserve Board has also determined seven activities which it has found to be clearly not related to banking. These are:

1. Equity funding, which is the combined sale of mutual funds and insurance.
2. Underwriting life insurance that is not sold in connection with credit transactions of the bank holding company or a subsidiary.
3. Real estate brokerage.
4. Land development.
5. Real estate syndication.
6. Management consulting.
7. Property management services.

During the course of the Board's deliberations, a number of individuals and groups raised serious questions and made representations concerning several of the activities which the Federal Reserve Board had determined to be ``closely related to banking`` and, therefore, which can be

carried on by bank holding companies. These include acting as investment advisor to Real Estate Investment Trusts and mutual funds, the leasing of personal and real property, the providing of bookkeeping and data processing services and operating insurance agencies. The result has been that the House Committee on Banking and Currency has urged further amendments to the Bank Holding Company Act in order to ensure that the Congressional intent of the 1970 Act is carried out. The House Committee interprets this intent to be to protect the legitimate interests of small business groups against the activities of bank holding companies, particularly large bank holding companies. Among the further amendments suggested are the following:

— Prohibit bank holding companies from engaging in non-banking activities unless specifically sanctioned by State Law.

— Prohibit bank holding companies from providing non-banking services to borrowers.

— Prohibit bank holding companies from providing non-banking services in market areas where the same institutions offer credit.

With respect to the United States, therefore, it seems that an unequivocal definition of banking is also lacking. What is clear, however, is that the United States and Canadian legislations seem to be in agreement over what should be strictly prohibited. Furthermore, we interpret the current trend in the U.S. as restrictive, in contrast to the previous expansionary climate. We should point out that, although investment advisory services, fiduciary powers and insurance services have not been undertaken to a great extent by Canadian banks to date, they have been actively pursued by U.S. banks. The pressure from U.S. authorities and groups or individuals has been towards a return to a more traditional monetary intermediary function of banking. Representations have indicated that the U.S. banks' expansion into non-banking activities has not served the economy well and there is a suggestion that more restrictive legislation would provide greater financial efficiency in the system.

. PROPOSED CHANGES IN LEGISLATION

In conjunction with existing statutes we must consider proposed modifications:

A. Canada: The Porter Commission

The Porter Commission offers a definition of banking by initially distinguishing between the asset and liability sides of the balance sheet. However, unlike the present Bank Act, the definition found in the Porter Commission de-emphasizes the asset side. The Report suggests that no legislative distinction should exist between banks and other financial institutions simply on the basis that they each make particular kinds of investments. That is, the Report argues that while it is true that trust and mortgage loan companies may not now make ordinary and personal loans, their money market, security and mortgage investments are often close substitutes for such loans and are interchangeable in any event wih a large segment of the assets of chartered banks. Thus, in the Commissions's view, any definition of banking and, of course, all federal banking legislation which relies on this definition to prescribe its jurisdiction, must focus on all private financial institutions issuing banking liabilities rather than on the assets of all these institutions.

The liabilities are seen as being of two types: claims serving as means of payment or close substitutes for them (i.e. demand deposits), and term type deposits. Demand deposits themselves can be differentiated betwen those claims which are transferable immediately, or on short notice by cheques or on customers' orders, and those claims which are not transferable. However, the Commission suggests that no really meaningful line can be drawn between the two since both pose the same public interest protection problems. Included under ``term deposits`` are all deposits, whatever their formal name, and other claims on ``banking`` institutions maturing, or redeemable at a fixed price, within 100 days of the time of original issue or of the time at which notice of withdrawal is given by the customer. Thus, in the Porter Commission's view, any institution whose liabilities can be characterised as above is engaged in banking and must therefore be subject to the provisions of the Bank Act.

To this broad definition of banking, the Commission adds several exceptions in order to exclude certain specific financial institutions which cannot or need not be regulated by federal authorities. Excluded are:

- — provincial government agencies accepting deposits;
- — deposit-taking institutions dealing with less than fifty people;
- — Institutions which borrow from a broad public, but whose only short term liabilities are in the form of marketable paper not redeemable on demand or short notice, and which sell these liabilities through independent dealers or other agencies subject to the prospectus and other requirements of the Securities Act.
- — Investment dealers and stockbrokers holding customers' funds or borrowing from others on short-term.

The Porter definition of banking, therefore, clearly embraces deposit-taking institutions other than the chartered banks.

By attempting to redefine banking on the basis of liabilities the Porter Commission does indicate that a monetary function is best served through a banking system which maintains the principle of monetary exchange. Porter hinted at the importance played by maturities on the liability side, suggesting that deposits of 100 days or more should be considered as term deposits. The nature of the assets of financial institutions involved in banking is a lesser consideration in the Porter Commission Report and there is no comment made on the nature of the relationship between the liability and asset sides of the balance sheets of financial institutions.

The United States — The Hunt Commission

In 1973, the President's Commission on Financial Structure and Regulations[1] (The Hunt Commission) made recommendations which, if implemented, would result in changes to the definition of banking presently implied in the Federal Reserve Board's rulings on non-bank activity. With respect to commercial banks the commission recommended, among other things, that:

1. The Federal Reserve Act be amended to permit discounts of, or advances against, any class of asset held by member institutions at Federal Reserve Banks...
2. Special statutory and regulatory restrictions on real estate loans by commercial banks be abolished.
3. Commercial banks be permitted to make equity investments in community rehabilitation and development corporations engaged in providing housing and employment opportunities for low and moderate income persons in aggregate amounts not to exceed 5% of capital, surplus and undivided profits.
4. Via a "leeway provision" and in addition to other specific powers, commercial banks be permitted to invest in any assets in amounts to aggregate not more than 3% of total assets or 30% of capital, surplus and undivided profits, whichever is less, provided that no equity securities other than those of their own subsidiaries and equity investments that are directly ancillary to and simultaneous with a particular lending operation may be acquired, and further provided that this "leeway" not be used to circumvent lending limits on loans to any one person, co-partnership, association or corporation or restrictions on loans to bank examiners, executive officers or bank affiliates.
5. Liabilities of any term incurred by commercial banks through the temporary or contingent sale of assets should not be defined as deposits of the bank.
6. Commercial banks be permitted to issue subordinated debt instruments of all maturities provided that maturities and yields, conditions of subordination, the lack of insurance and other differences between the debt instruments and deposit liabilities are clearly and fully

(1) Report of the Senate Committee on Banking, Housing and Urban Affairs, Washington, D.C. (December 1972) G.P.O. Cat. No. 99-4470

disclosed to all purchasers, and provided that these issues are evaluated and approved as bona fide capital by the appropriate supervisory authority prior to issue.

7. Commercial banks and their subsidiaries and holding company affiliates be permitted to manage and sell mutual funds, including comingled agency accounts, subject to regulation by the Securities and Exchange Commission.
8. Commercial banks and their subsidiaries (in addition to their existing authority to underwrite revenue bonds classified as general obligations) be permitted to underwrite revenue bonds secured by revenues from essential public services...
9. ... commercial banks and their subsidiaries be permitted, upon individual application, to engage in a variety of financial, fiduciary or insurance services of the type, but not more extensive than, those approved for bank holding companies by the Board of Governors under the Bank Holding Company Act.

After listing these and other recommendations the Report then continues by pointing out that the unique feature of commercial banking, and therefore a feature crucial to its definition of banking, is that these institutions are generally permitted to offer unrestricted third party payment services. That is, they operate the mechanism for check funds transfer and, in their lending and investing operations, create money. In all other activities they compete with other financial or non-financial institutions.

The Report neatly summarizes the before and after status of commercial banks as follows:

Before	**After**
Deposit Powers	
Payment of interest: severe restrictions on all types of deposits.	Payment of interest: 5-1/2 year phase-out of interest restrictions, then freely determined. However, no interest on demand deposits.
Savings accounts: individuals only.	Savings accounts: full powers: individual and corporate.
Demand accounts: full powers: individual and corporate.	Demand accounts: full powers: individual and corporate. (no change).
Negotiable Order of Withdrawal (N.O.W.) accounts: not permitted.	Negotiable accounts; full powers; individual and corporate.
Lending and Investment Powers	
Real estate loans; severe restrictions re: collateral, loan size, maturity and method of repayment.	Real estate loans: modest restrictions re: collateral, loan size, maturity and method of repayment; community rehabilitation loans under a 3% leeway added.
Equities: holdings severely restricted.	Equities: holdings severely restricted.
Summary	
Consumer interests penalized. Opportunities to compete for funds limited and prohibitions restrict direct participation in housing and real estate finance. No mortgage investment incentives such as granted to the savings and loan institutions.	Consumer interests given high priority. Virtually unlimited opportunities to compete for funds; restrictions against housing and real estate finance modified, and positive incentives for such investment, identical to those given the savings and loan institutions.

At the same time that the U.S. banks were being reviewed in terms of their activities by the Hunt Commission, there was an investigation into the potential and actual conflict of interest situations which arise from either bank ownership of certain classes of assets and interests or the banks' fiduciary activities. Although the U.S. banking structure is substantially different from ours, they have experienced permissiveness in bank activities to a greater degree than we have and are intent upon reversing the direction by reducing the banks' powers of expansion and confining their activities to a more traditional banking function.

Most of the concern expressed in the U.S. has been directed toward potential conflicts of interest. We should bear in mind that the U.S. banking industry is comparatively fragmented, despite the great size of individual banks. If even the "restricted" powers suggested by the Hunt Commisssion were authorized for Canadian banks, our prime concern would become concentration of power.

The changes to the banking laws which we have outlined above and which were the offspring of the Hunt Commission, represent the high water mark of the generalization trend. It seems clear from the developments and the representations that have taken place since then, that the problems of generalization versus specialization and the difficulty of specifying "bank-related activities" had been the major issues leading up the legislation following the Hunt Commission.

The legislative changes enacted subsequent to the Hunt Commission recommendations represent the culmination of a previous trend and not the current thinking. The problems and controversies which have occurred since have reversed the tide and the current trend appears to have abandoned an attempt to set limits to generalization or to qualify bank related activities. Instead it seems to wish to identify banking functions rather than bank related activities. Representations made to Congressman Wright Patman strongly indicate a desire for a definition of banking based on monetary functions rather than financial activities. We suggest that we have the opportunity in Canada to profit from U.S. experience by avoiding the establishment of the conditions giving rise to expansionary excesses.

4. THE NATURE OF BANKING

The definitions of banking which we examined in the previous section describe the allowed role of a financial intermediary carrying out the business of banking. We have therefore examined the objects and powers of trust and loan companies in Canada and bank activities in the U.S. and Canada. The proposed amendments to the statutes have provided us with a view of what changes the political and social system wishes to incorporate into the statutes in order to update the roles of banks and trust companies to the current needs of our society as well as to remedy some of the problems which previous statutes have engendered.

Since the objective at hand is to improve the financial system as a whole for the greater economic good, an investigation into the true nature of banking appears logical at this point. We can now examine the relationship between money, its role and characteristics and influence on the nature of banking and concurrently look at the nature of intermediation which will assist definition of the banking function within the entire financial system.

The principal aspects of the banking function involve firstly the definition of money and secondly the economically efficient operation of a financial intermediary. Since the deposit liabilities of banks must be considered as money they must have the characteristics desirable to money. Since banks are expected to operate an efficient exchange of funds between users and depositors, they must maintain the characteristic of an intermediary. Combining banking with intermediation requires that the relationship between the saver and the investor be maintained under the very special condition that the funds deposited must retain their monetary characteristics.

The characteristics of money are firstly that it must be acceptable as a means of payment, secondly that it can serve as a store of value and thirdly that it can be a unit of account. The generic term money denotes a whole class of financial assets that share a common characteristic: general and direct acceptability as a means of payment. Any financial institution that is intended to maintain ''general'' and ''direct'' acceptability of its deposit liabilities must in turn have a very specific asset portfolio structure which will enable it to maintain monetary characteristics. Such a portfolio must be evaluated by liquidity and degree of risk. In relative terms, for an asset to be used or considered as money, it must be as liquid and as riskless as possible.

In the final analysis there are two criteria that are central to the nature of a banking operation: the bank's liability characteristics and its intermediation function. The two are interrelated to a degree though they will be considered separately below.

A. Intermediation and Banking

The nature of intermediation implies an interposed third party acting between two other parties without having a vested interest in either side specifically. The true nature of intermediation implies that the intermediary acts between surplus funds and deficit funds units. The surplus funds originate by way of deposits or savings and they are transferred to fill deficit needs by way of loans or investments.

One of the principal roles of banking is the ability to perform a transmutation from assets which are characterized by uncertain capital value and liquidity into bank deposits of high liquidity, convenience, certain redemption value, general acceptability as a means of payment and in some instances certain income yield. The result is reduced risk and the convenience of direct monetary asset ownership for the individual saver. Accordingly, the intermediary carrying out the banking function must be able to have and retain the flexibility of transmutation. To retain this flexibility and guarantee the nature of money characteristics that its liabilities must retain, it cannot serve two masters. It cannot be an owner acting for itself and an agent acting for savers and borrowers simultaneously. These are the general principles which exclude banking from commerce or trade through ownership of goods or services.

The bank's objective should be to maximize its profits and its market potential as a monetary intermediary but not as owner of goods or purveyor of services.The instant a bank undertakes to assume ownership it then assumes the position of a principal acting for its own profit through the

realization of profits derived from ownership. This condition violates the basic principles of monetary intermediation which stipulate the neutrality of the banking intermediary.

The question of ownership for the purpose of commerce is especially relevant in the case of banks since it touches on two critical points: conflict of interest and the nature of money. The conflict of interest cases that have arisen in the world of banking have nearly always originated from a situation where a bank has departed from its true function of monetary intermediation. Usually, the bank assumed a vested property interest which shifted its profit motive or interest from its monetary intermediation function to the expectation of gain from trade through ownership.

Monetary intermediation, or banking, is a specific intermediation function. To achieve economic efficiency and fulfill a desirable economic role, a financial institution which provides money to savers must have monetary intermediation as its sole profit source and motive. The existence of a second profit potential introduces a choice which may result in actions being taken which deviate from economic efficiency. Assuming that the profit motive remains the driving force behind corporate decision making, if a monetary intermediary now has the expectation of earning a greater profit from a non-banking function, it may neglect its monetary intermediation function in favour of a new profit objective. Although maximum returns can be earned in two functions by the same institution, eventually a situation is bound to arise where the institution will choose one route and reject the other. Therefore, a distinct danger exists that, in pursuing non-monetary intermediation functions, an institution will relegate its intermediary function to a status which achieves a lesser degree of economic efficiency. This is the reason why, to maintain an efficient monetary system the integrity of the banks' role must be retained and cannot be diluted by non-banking activities.

We have briefly outlined the economic pitfalls associated with financial monetary intermediaries having the option to profit from non-banking functions. The more obvious problem, which finds ample evidence in court cases, is that of legal conflict of interest which arises when an institution whose purpose is to provide a service to the public neglects its responsibilities to serve its self-interest.

B. Liability Characteristics and Banking

In the second instance, the true nature of money held by banks can only be maintained as long as whatever assets are held are transmutable on demand into cash. The ability of a bank to transmute its assets into cash must not be put at risk by the expectation of additional profit over and above the profit from the process of transmutation. It must clearly be understood that an intermediary's profits arise from the process of intermediation and transmutation.

The process of monetary intermediation however implies that the bank provides a specific liability with high liquidity and acceptability whilst it assumes assets of lesser liquidity and acceptability as a means of exchange. The profit is realized both from the undertaking of the risk difference between assets and liabilities and through the economies of scale that exist in the

banking business. The economies of scale in intermediation are achieved for example when a large number of small depositors are pooled and a single borrower can benefit from this pooling. They are also achieved through firm or institution size. Efficiency in achieving economies of scale and in pooling financial resources is the key to banking profits. Undertaking the risk difference between assets and liabilities is a source of profit limited for the banks by the crucial constraint which stipulates that depositor demand withdrawal rights must be maintained and consequently that liabilities must have monetary characteristics.

To preserve the ability of a bank to transmute its assets into cash requires that its assets retain a high degree of marketability. This can be accomplished only by investment in low risk, short maturity instruments. By definition, the risk difference and resultant profitability is limited, increasing the temptation to abandon rigid criteria in favour of higher profits.

The underlying assumption is that financial assets of similar characteristics but varying maturities will have different degrees of risk, the financial assets with the longer maturity bearing the greater risk.

This leads us to conclude that if the banking system is to maintain the money characteristics of its deposits it must be subject to specific constraints: transmutability of assets and the single profit possibility. Transmutability of assets guarantees the money characteristics through low risk assets and a high degree of liquidity. Low risk in turn is assured through the bank's legal rights to security and through limitations on maturities. It was considered earlier that longer maturing assets inherently contain a greater degree of risk, a lesser marketability and consequently a lesser degree of transmutability. Higher risk, longer maturities of assets in a bank's portfolio will dilute the money characteristics of bank deposits. To the extent that this exists, it is not desirable for banks to assume long maturities in their assets and the banking system should consequently be limited in assuming long maturities in its asset portfolio.

The direct ownership of assets creates both a profit motive confusion and a potential conflict of interest problem and therefore a reduction in the transmutability of assets. The constraint which potentially exists when the ownership in expectation of gain can play a conflicting role with pure intermediation also affects the transmutability of an asset, not necessarily because it reduces its liquidity or marketability but because it may alter the proprietor's willingness to undertake the transmutation. This is a strong enough potential danger that it must be avoided at all cost. The banking system must therefore be prohibited from any form of ownership which may give rise to an economic as well as legal conflict of interest. It may only undertake such ownership of goods as is directly related to the performing of an intermediary function.

In conclusion, the true nature of banking requires a specific relationship between the assets and liabilities in the banking system. On the liability side we have shown that the money characteristics of bank deposits must be maintained; on the asset side we have seen that the total portfolio must be liquid, low risk, and with short maturities to guarantee the transmutability of financial assets into money. As between assets and liabilities we have determined that a possible conflict of interest derived from direct ownership may result in the reduction of transmutability as well as in a host of other legal and moral problems and therefore the banking system must be precluded from the direct ownership of goods for gain.

BANK AND TRUST POWERS RELATED TO THE NATURE OF BANKING

The abstract illustration of the nature of banking developed in the previous section can be developed further by itemizing the corresponding powers of certain financial institutions. The review of the U.S. and Canadian banking regulations as they exist and as they are proposed

indicate three things: first some proposed amendments to the definition of banking would embrace a greater number of financial institutions, primarily the non-bank financial intermediaries. Secondly it would specify banking activities more rigidly, with the U.S. placing an emphasis on conflict of interest problems that may arise from ownership or from the combined trust and banking functions. Lastly, government authorities have indicated a desire to guide financial institutions into socially desirable areas and have consequently fostered portfolio reallocations in the banking system. For example, the pressures to redirect financial assets to the mortgage market have been a result of social urgency: they have not come about as a result of a logical extension of banking activities.

A. Bank Activities

The specific activities of the banking system as they relate to our views of the nature of banking can be itemized in contrast to the definition by exception which exists under current statutes. Indeed, on both the uses of funds side and the sources of funds side, the banking activities may now be identified to meet the criteria that we have set previously. The liability and asset sides of banks would be as follows:

SOURCES (Liabilities)

A. Deposits: Demand, Notice—(Savings), Term—(100 day maximum)

B. Borrowing: debentures —5 year minimum maturity

C. Capital

USES (Assets)

A. Reserves

B. Lending—short term commercial and personal loans, secured and unsecured. (Mortgages as one current exception)

C. Investment-discounting of commercial paper, foreign exchange transactions, gold and silver coin and bullion, securities with limits on quantity and percentage of ownership.

i. Sources (Liabilities)

Specifically, on the liability side, the deposit function is emphasized to retain the banks' ability to serve the monetary requirements of the economy. It may be stated briefly that the Porter Commission arbitrarily recommended a 100 day maximum term to banks term deposit liabilities. It also corroborates the principle that an institution which has a short term asset portfolio should support this portfolio through short term liabilities. If this principle were not upheld, banks could support short term assets with long term liabilities thus skewing unnecessarily the structure of the financial system and unfairly competing with institutions attempting to support long term assets with long term liabilities.

Any liability undertaken by the banking system beyond short term deposits should therefore preferably be only in the form of a debenture supported by the full faith and credit of the bank. We support the restriction that debentures issued by banks should have minimum maturities of five years. The constraint imposed ensures that the banks enter the long term market as any other corporation on the strength of their own credit rather than on the strength of the monetary characteristics of a term deposit. The essence of this argument allows other financial institutions seeking longer term liabilities to have free access to this market. In addition to this, nothing prevents banks from issuing their own equity to increase their capital base.

ii. Uses (Assets)

On the uses, or assets side, the overriding criterion is the retention of the money characteristics of the banks' liabilities by containing bank activities to short term lending or investing and thus ensuring a high degree of liquidity and transmutability. Reserve requirements were originally imposed to guarantee a certain degree of liquidity to ensure the stability of the system. Later their principal use came to be as instruments of monetary policy although they still fulfill the liquidity function in the banking system.

Lending, which is the true function of the banking system on the asset side, must also be guided by the criterion of transmutability which requires that lending be of a short term nature. The risk limitation criteria are met through the normal short term and cash flow nature of lending contracts as well as through the undertaking of guarantees, collateral or other security under the umbrella of Section 88 of the Bank Act.(1)

Investment is recognized as the other asset function of banks. Investment by chartered banks provides them with the means of earning a return on those surplus funds which are awaiting short term loan demand. The concept behind the banks' investment function is clearly one of taking care of surplus liquidity. By the same token liquidity levels which are forced upon the banks, such as secondary reserve requirements also require an investment medium. In this segment of the banks' portfolio the restrictions are mainly centred around the problems of ownership. As an intermediary and in order to maintain a certain level of assets yielding a return but also providing near liquidity, banks have traditionally acted as discounters of short term commercial paper, have entered into foreign exchange transactions and have purchased and sold obligations, securities and various other financial assets such as gold and silver coin and bullion. The investments must be limited both as to the length and intent of possession.

The question of conflict of interest can be overcome by imposing restrictions on bank investments both in terms of aggregate sums invested in one financial asset and in terms of the degree of ownership or control that the bank's position may have on the issuer of the security. Although we need not go into details in this paper, it may be sufficient to say that the existing rules for investment should be adjusted to conform to the banking activities outlined above.

Since we have established guidelines to banking and consequently identified the allowable activities of the banks, it behooves us to examine the relationship that the trust and loan companies have with banking.

B. TRUST AND LOAN COMPANY ACTIVITIES

Trust and loan companies have the peculiar characteristic that their business is divisible into a fiduciary function and an intermediary function. Furthermore in their intermediary capacity, the trust and loan companies have traditionally restricted themselves to a specific segment of the financial market.

i. Specific Characteristics of Trust and Loan Companies

In their process of intermediation, trust and loan companies have tended to the longer term maturities both on the asset and liability sides and have consciously sought to match maturities. It should be added that the degree of certainty derived from a matching of maturities is probably a contributing factor to a reduction in the spread between the borrower and the lender. This exists by virtue of the fact that matched maturity portfolios reduce the uncertainty associated with the expectations of future interest rise or fall. Consequently, the trust and loan companies' practice of matching maturities to a larger degree than banks has allowed them to provide mortgages at a lower cost than otherwise possible. Since trust and loan companies are heavily involved in the

(1) For additional comments, see the Section, "Long Term Debt Instruments & The Canadian Financial Institutions."

mortgage market it may be argued that this function should be retained and that the ability to match maturities will prove to be commercially efficient and socially beneficial.

In the second instance, contrary to the banks, trust and loan companies are not creators of money per se. Although they create financial assets which some people consider and use as money, these financial assets differ from the banks' liabilities in that they constitute a trust relationship between the deposit holder and trust company, versus a liability in the case of the banks. From an economic point of view the argument states simply that if a financial asset is largely accepted and utilized by people as a monetary instrument then it is money and should be subject to the regulations and stipulations in the same manner as all other money. We have no quarrel with this viewpoint and it is also argued that to the extent that trust and loan companies create financial assets which resemble or are deemed to be money then they should be subject to the same constraints which are outlined previously for banks. Basically, this would imply that all short term liabilities of the trust and loan companies should be subject to the liquidity and transmutability conditions.

Liquidity and transmutability already exist by virtue of the liquidity requirements imposed on trust and loan companies: the assets retained to cover 100 day maturities are practically equivalent to the secondary reserve requirements of banks and are almost perfectly transmutable into cash by virtue of the marketability of the securities which are eligible under the regulations. The conditions are therefore met to a large degree even though the actual relationship between depositors in a trust company is that of depositor/trustee whereas in the case of banks it is that of creditor/debtor. By entering into a trust relationship with its depositors, it could be argued that the trust company does not place itself in exactly the same position as a bank vis-à-vis its depositor and therefore a lesser degree of transmutability could be acceptable for the short term assets of trust and loan companies.

This is a moot point which need not be debated since it appears that the conditions inherent to the characteristics of money have been met for the short term liabilities of trust companies.

As we look at the portfolio of trust and loan companies we notice, first that the remainder of trust company liabilities are also held in trust, and secondly that both trust and loan company liabilities lose their money characteristics. Guaranteed Investment Certificates or Term Deposits varying from six months to five years are not considered to be a generally accepted means of exchange, or units of account although they may be considered as a store of value. The latter quality is a necessary condition but not sufficient in itself for a financial asset to become money. This means that the degree of transmutability required in the aggregate is much less important in trust company portfolios than for banks where a far higher percentage of liabilities are demand deposits or short notice savings deposits. Therein lies a major difference which permits the trust companies to be subjected to different criteria by virtue of their different portfolio structure and intermediation role.

A review of the Canadian financial system indicates that specialization in the financial markets already exists to a large degree on the liabilities side of banks and trust and loan companies. Only recently has there been an increasing degree of overlap between the two institutions, the most evident intrusions being the banks' entrance into the mortgage and the long term borrowing markets, whilst the trust and loan companies have stepped up their financial intermediation activities[(1)]. The pursuit of economic efficiency stipulates that if financial intermediaries can operate in a world of near certainty, then the margins taken will not need to include the cost of uncertainty and can be reduced to the greater benefit of the public. We have also indicated earlier that matching maturities contributes to a reduction in uncertainty and consequently is desirable.

(1) See following section: **Current Activities of Chartered Banks and Trust and Loan Companies.''**

The concept of matching maturities excludes the long term borrower from lending short and vice-versa. If we apply this principle to both the trust and loan industry and the banking sector, banks would be restricted to demand or savings deposit borrowings. We consider the banks' involvement in the mortgage market as an aberration expediently brought about by demographic problems and short term social needs. In the event of a decline in mortgage demand, the role of chartered banks as expedient stopgaps would no longer be required and mortgage lending should be removed from the banks' activities. As indicated earlier, if banks' assets are to counterbalance money type liabilities then mortgage assets do not qualify. Objectively therefore in the light of a demographic forecast indicating a decline in the housing start demand at the end of the next decade, consideration should be given before that time to phasing banks out of long term borrowing and mortgage lending markets in favour of the traditional long term lenders and borrowers.

Bearing in mind the characteristics peculiar to banks and to trust companies, we can now consider the relationship that trust and loan companies have with the nature of banking, specifically with respect to intermediation and to the monetary characteristics of liabilities.

a) **Intermediation:** trust and loan companies can be truly considered as financial intermediaries, acting as agents between savers and borrowers. In the case of trust companies, the intermediation role which they perform is only part of their total business. In fact, historically the intermediation function has occurred as an extension of the pure trust function. The administration of estates, for example, will naturally lend itself to the provision of certain personal financial services such as residential mortgage lending, taking savings deposits or making personal loans.

It is appropriate at this point to look at the two factors which we considered as important for banks in defining the nature of banking: neutrality and transmutation.

We have established above that the great majority of the liabilities of a trust or loan company do not have monetary characteristics and therefore do not need assets that are correspondingly transmutable. The structure of liquidity requirements of a trust and loan company is such that the transmutability is taken care of by requiring the companies to hold liquid assets in proportion to its maturity schedule, thereby ensuring the transmutability of assets that correspond to short term or demand liabilities. Beyond this point, since trust and loan companies liabilities are no longer required to have money characteristics, the corresponding assets lose the need to be transmutable.

The distinct difference that exists on the liability side of trust and loan companies make it possible for these to avoid being entirely subject to the criterion of transmutability. Consequently, it is acceptable that trust and loan companies should be subject to a banking definition to the extent that some of their liabilities confer monetary characteristics, provided that the banking constraints imposed on trust and loan companies be limited to this short term liability segment. This condition exists under the present system: if trust and loan companies extend their demand deposit liabilities they are still subject to liquidity requirements based on maturity schedules rather than a total volume of deposits. This method of regulation permanently assures liquidity and transmutability.

As a corollary, however, there is nothing within the logic of our definition of the nature of banking which precludes trust and loan companies from extending their short term deposit-taking activities since they remain constrained by maturity criteria. Those who wish to argue that trust and loan companies will intrude into the short term or demand deposit market and lend on the long term basis will also realize that the liquidity requirements structure imposed on trust and loan companies does not lend itself easily to this practice. In fact, short term liabilities of less than 100 days are generally well covered by cash and marketable short term assets. The financial intermediation aspect of trust and loan companies appears to meet the criteria of transmutability, liquidity and intermediation efficiency.

The last aspect which we cover is the problem of conflict of interest as it was depicted arising from banks taking up ownership of goods for direct profit. First, we must remember that one of the difficulties in having banks carry on commerce for their own account is that it may reduce the degree of transmutability of the assets by virtue of potential conflict of interest arising out of two profit possibilities. In the case of trust and loan companies we have determined that conflict of interest through direct ownership is less likely to arise. Ownership which leads to a potential conflict of interest in the case of banks generally arises from the possession of a fixed asset or a significant investment in an equity position. While the banks could experience this problem by using any of their liabilities the trust and loan companies are not similarly susceptible. The maturity scheduling of liquidity requirements hampers trust and loan companies from using short term liabilities to take up ownership for the sake of commerce. This has been evidenced by past experience.

Second, trust and loan companies, by virtue of their involvement as trustees have developed very stringent policies and practices regarding potential conflict of interest from ownership in addition to a degree of statutory regulation such as Section 163 of the Ontario Act. Thus, precedents exist to overcome the potential conflict arising out of serving two masters. This problem is different from that of a conflict of interest which may arise and lead to a reduction in the transmutability of an asset. The question of asset transmutability is less a moral question than an economic one.

In the case of trust and loan companies, since the question of transmutability only arises in their short term liabilities and has been well covered by liquidity requirements, there is consequently no logical reason to preclude trust and loan companies from ownership of an asset for the sake of commerce. Indeed the non-monetary characteristics of the majority of aggregated liabilities of trust and loan companies point not only in the natural direction of longer term maturity assets but also permit long term investment positions and ownership. Thus, economically, the ownership of assets for gain in commerce or trade is not a contradiction to the proper carrying out of the trust and loan functions while conflicts of interest are appropriately covered through stiff regulations founded in trustee law.

ii. The Liability and Asset Characteristics of Trust and Loan Companies

We have centred our definition of banking around the concept of money and its necessary characteristics and we have consequently determined the role that banks must play within the financial system in Canada. We can use the same definition and apply it to trust and loan companies in order to structure a role for the trust and loan industry.

Bearing in mind that a substantial portion of trust company business is derived from fiduciary functions, we shall limit our comments hereunder solely to the financial intermediation aspect of their activities, to maintain relevance to the banks' situation.

The specific intermediary activities of trust and loan companies can therefore be itemized as follows:

Sources (Liabilities)

a) Deposits: chequable, notice

b) Borrowing: Term, GIC (restricted in proportion to capital) for trust companies, debentures for loan companies

c) Subordinated Notes

d) Capital

Uses (Assets)

a) Required liquidity: cash and short term securities

b) Lending: mortgages, personal, secured loans

c) Ownership and Leasing

d) Basket Clause

a) Sources (Liabilities)

The important point to recall is that the monetary characteristics of trust and loan company liabilities only extend to demand and chequable deposits and the asset side must conform to the rules applied to banks to maintain these characteristics.

b) Uses (Assets)

On the asset side liquidity requirements provide the assets which must relate to short term deposits to maintain the monetary characteristics of the latter. Other assets are constrained by legal restrictions. Economically we have seen that mortgages, fully secured loans as well as ownership and leasing arrangements are an acceptable adjunct to the nature of the longer term liabilities.

The "basket clause" allows a limited amount of portfolio investment in unsecured loans or assets of a riskier nature, including ownership. We discuss the possibility of an expansion of the basket clause in the chapter on reserve requirements. The guiding principle here dictates that the greater the accessibility that institutions have to short term liquidity the broader their basket clause may become.

We have identified that the respective roles of banks and trust and loan companies with respect to the nature of banking centre around the characteristics of money. Even though this paper has been limited to the principal participants in the Canadian capital market, needless to say the same rigorous definition of banking can lead to a specific role definition for all financial intermediaries in Canada.

C. Conclusions

In reviewing the above sections we conclude that:

1. The nature of banking can be defined to improve the operation of the Canadian financial system;
2. Banking and the roles of banks can be itemized rather than defined by exception as under the present Bank Act. The attempts to define the extent of generalization versus specialization and of identifying "bank related" activities must be abandoned in favour of a fundamental approach based on the definition of money and its role in the financial system.
3. Banking can be defined by using as a guiding principle the identification of monetary characteristics and the corresponding function of banks within a monetary system.
4. Monetary characteristics of liabilities necessarily imply asset transmutability, corresponding liquidity and efficient intermediation.
5. The transmutability constraint limits banks from long maturity investment and precludes them from the ownership of good for gains in commerce.
6. The definition of the nature of banking implies that those who provide money type liabilities are in a specialized market and must restrict themselves to that market lest they enter into a conflict of interest and reduce the economic efficiency of the financial intermediation system and reduce the effectiveness of monetary policy.

6. CURRENT ACTIVITIES OF CHARTERED BANKS AND TRUST AND LOAN COMPANIES

A review of the statutes for the trust and loan industry and for the chartered banks provides us with a clear picture of the legislation. An evaluation of the proposed amendments to the existing legislation in the U.S. and Canada has also provided us with a notion of the adjustments to the legislation which would be required to bring the operations of the trust and loan companies and of the banks closer to the current social objectives.

The actual practices of trust and loan companies and of banks require examination in order to estimate accurately their actual functions in society relative to their intended functions as interpreted through legislation.

We will therefore examine the present nature of both trust and loan company operations and of bank operations, with specific attention to their diversification into new areas of financial or other endeavours.

To maintain relevance, we have limited our review to the activities of trust and loan companies and chartered banks only. An investigation into the activities of all other Canadian financial intermediaries would undoubtedly prove interesting but would be less relevant to the present nature of banking within the Canadian financial system.

A. The Present Nature of Trust and Loan Companies Operations

To compare operations with statutory objects and powers, trust and loan activities must be considered, and considered separately under the headings of their fiduciary, i.e. personal and corporate trustee function and their intermediary function.

i. Personal and Corporate Trustee Function

a) Personal Trust—Estate Trust and Agency business.

Personal trust functions comprise three main types of account: estates, trusts and agencies (E. T. & A.). Real estate services are closely related, but operated separately. As at December 31, 1974 trust companies in Canada administered E. T. & A. assets of a total value of $30.09 billion.

Estate administration arises from the appointment of a trust company as executor or co-executor in a testator's will. On the testator's death the will is probated, and the assets of the estate are listed, valued and appropriate tax returns made; succession duties, income taxes including capital gains and other liabilities are paid; the assets are collected and transmitted; any distributions stipulated are made; and if an ongoing trust is established under the terms of the will the trust company as trustee will manage the assets as directed. Other normal services performed include the collection of interest and dividends, income disbursement, regular accounting reports, investment reviews and consultations with beneficiaries and co-executors. The investment of the assets of trusts arising from estates is governed by the terms of the will or, if not specified, by the statutory rules governing trustee investments.

Apart from testamentary trusts, trust companies are involved with three main types of trusts.

a) those established for the benefit of living persons;
b) charitable trusts;
c) tax-sheltered trusts, such as registered retirement savings plans and registered home ownership plans.

The trust company performs its services under the terms of a trust agreement in return for an annual fee.

When a trust company acts as agent in the management of clients' funds, its responsibilities can range from safekeeping only to full investment counselling and accounting, depending on the

type of agreement entered into. In all cases the trust company holds the assets in safekeeping and is responsible to its principal, normally a living person, corporation or charity. Many individual portfolios are managed on an agency basis and provision is made for the smaller investor through a variety of funds, which constitute a significant part of the trust industry's business. Most trust companies offer a wide variety of pooled or comingled funds including equity, bond and mortgage funds.

Trust companies offer two types of real estate services — property management and brokerage. The property management side consists of managing income properties on behalf of owners, looking after maintenance, payment of taxes, receipt of rents, leasing and so on. Real estate brokerage is far more important to most trust companies. The bulk of this business comes from the buying and selling of houses on behalf of individuals.

b) Corporate Trust

Corporate trust functions involve activity in three areas: stock transfer and registrarship; corporate bond and debenture trusteeship; and pension funds trusteeship.

The great majority of public companies in Canada employ a trust company to act as transfer agent and registrar for their preferred stock, common stock and warrant issues. A transfer agent arranges and accounts for the transfer of ownership of a company's equity securities. As transactions take place, the agent will cancel existing stock certificates and issue new ones. A registrar complements a transfer agent by keeping a master record of securities outstanding since the number of shares and warrants issued and outstanding must balance with the number authorized. In effect, the registrar's function serves as a check on the stock transfer function. It is now common practice in Canada for the same company to act in both capacities.

Bond trusteeship involves the holding of security, the exercise of discretion and the amendment of indentures, a highly technical field. When companies issue bonds or debentures a trust company is appointed as trustee for the issue. The trust company essentially acts as a "watch dog" for the holders of the securities: paying bond interest, making sure that the issuer adheres to the provisions contained in the indenture covering the securities, and taking action to protect the interests of the security holders in the event of default. Other services performed by the trustee include: holding and investing the proceeds of issues and making progress payments; handling sinking fund operations; calling bonds for redemption; processing their conversion where applicable; and registering and exchanging bonds. The total value of securities outstanding as at December 31, 1974 in respect of which trust companies acted as trustees, stood at $21.45 billion.

Trust companies acting as trustees for pooled and segregated corporate pension funds normally have complete custody and control of the funds including investment management. In some cases the employer appoints outside investment counsel to manage the portfolio. Pension trusteeships are an important and growing segment of trust company operations as is witnessed by the fact that of the $30.09 billion assets mentioned earlier in the chapter, $7.45 billion represented assets of registered pension plans.

ii. Financial Intermediary Function

In the previous section we have summarized the trust companies' main fiduciary activities. The financial intermediary services they currently offer are described in this section. The legal nature of the intermediary activity was reviewed in the section of this submission dealing with the statutory powers of trust companies.

Trust companies act as financial intermediaries by taking deposits in trust from the public and making loans with the funds thus collected. These funds are held in a guaranteed funds account and the bulk of the money is used to make first mortgage loans. The second largest category of

assets held are term bank deposits, treasury bills and bonds of various types required for liquidity purposes. The final category includes call loans, personal loans, real estate and various "basket clause" items. In addition to the investments listed above, the trust company's own assets, including shareholders equity, support the guaranteed funds.

Our intention with respect to the financial intermediary function is to examine the nature of trust and loan companies' expansion and diversification as it relates to their statutory powers.

There has been a gradual but significant trend towards expansion of business activities in a vertically integrated manner. Evidence of vertical integration of operations related to basic fiduciary activities is especially evident amongst the largest trust and loan companies. Firstly, those companies doing a major part of their business in mortgages usually have integrated real estate operating companies and mortgage insurance subsidiaries. In some instances, to facilitate construction and real estate development, companies have developed affiliates or subsidiaries to handle short term, medium term, and bridge financing loans to builders. As a further adjunct to their active role in mortgage financing, some companies also become involved as operators and holders of real estate. The ownership of real estate usually follows the development of a large project and is limited to certain specific projects where the magnitude of the development dictates that the mortgagor should maintain a degree of control over the development through part ownership. Real estate operating companies are an extension of the trust and mortgage business where the property owner may not be able or willing to handle the administration himself and wishes to delegate it to a professional manager whether under trusteeship or not.

Perhaps the most interesting and dynamic expansion of trust and loan activity over the past decade has been in the field of real estate brokerage. The entry into this business, whether directly or through a subsidiary has been swift and profitable, thus indicating that there existed a definite synergistic potential for a natural extension of trust and loan companies business. In general, trust and loan companies expanded their operations into this related field simply by making a more extensive use of their existing facilities and thereby achieving economies of scale.

Pursuant to the large volume of stock transfers, registration, accounting, record keeping and administrative items which trust and loan companies undertake in the normal course of their business, at least two companies have acquired equity interests in computer service companies. The companies that have extended their operations into computer services have done so more as an alternative to an in-house service than in order to enter another market. In fact, the logistics of the volume of records and transactions dictated the move. We suggest that this contrasts with the banks' modus operandi, which has been to market computer services actively after having built up a capacity substantially beyond internal requirements. We do not necessarily condemn this practice, which produces economic benefits both to the banks and their data service clients, but we suggest that it should be controlled in extent.

Although the trust companies have traditionally been active lessors of rolling stock, more recently they have expanded into equipment and machinery leasing on a broader basis. The move into the leasing business has been not so much through subsidiaries or affiliates than on an ad hoc basis, sometimes pooling the resources of more than one trust company to cooperatively finance a large piece of equipment; the prime example of this being the leasing of two Lockheed 1011 aircraft to Air Canada with three trust companies participating in the financing. Trust companies have accumulated a certain amount of expertise and experience in the field of leasing, starting with leasing or sale-lease back operations in the real estate business, going into bareboat ship chartering, which is a form of equipment leasing, and currently undertaking more widespread leasing of industrial equipment. It appears that the trust and loan companies' accumulated experience and their financial base would lead them naturally into the development of the leasing market at an accelerated pace in the future.

Trust and loan companies have also engaged in mutual funds and real estate investment trust activities to a varying degree. Foreign activities have been limited to representing the domestic interests abroad and engaging in financial intermediation or international banking. In the aggregate, however, the percentage of activities carried out by trust and loan companies on the foreign scene is very small.

Lastly, it should be remembered that in Canada, there is an established relationship between trust companies and mortgage loan companies with one being the other's parent or subsidiary as the case may be. This was probably the earliest form of integration in the business and many of the large trust companies have a mortgage loan subsidiary or vice-versa.

The activities outlined here represent the major areas of diversification of the industry and indicate that the industry as a whole has logically proceeded from fiduciary and mortgage lending functions into areas directly related to their business and naturally open to them.

B. The Present Nature of Chartered Bank Operations

There are presently certain unique characteristics of the chartered banks that confer substantial market power upon them. For instance, banks hold by far the largest amount of demand deposits. By virtue of the fractional reserve system, these deposits then provide a money-creating expansion base that enables commercial banks to dominate the short-term loan market, especially the short-term, secured and unsecured commercial loan market. In addition, there are barriers to entry into banking, including a rigorous process of incorporation and specific legislative approval for the establishment of new banks. Over and above these barriers is the division of market territories brought about by various legal and economic factors in the product markets where commercial banks compete with other financial institutions. For example, banks and trust companies compete for savings. However, the banks are much less dependent upon time deposits as a source of funds, since they have large sources of demand deposits. Accordingly, they need not offer high interest rates in order to attract time deposits. However, whenever banks have been interested in increasing their deposits they have aggressively bid for time deposits, forcing other market participants to offer higher rates and consequently incur higher money costs. Finally, the chartered banks enjoy unique relationships with their borrowers which enable them to achieve tying effects. That is, the borrowing relationship tends to be a continuing one and such a relationship requires considerable disclosure of confidential internal business information necessary for credit evaluation. A U.S. Department of Justice official points out the risk of tying as follows:

> ''In times of tight money, banks ''ration'' a scarce and essential commodity to ''good customers.'' When banks ''ration'' credit (or are forced to ration it) rather than raising the price to the point that supply and demand meet, the process produces unexercised monopoly power — power which must be abandoned or used through transfer into some other market. It can be done by tying. No conversion is necessarily involved. Rather, the borrower, recognizing the bank's discretion and economic power is tempted voluntarily to patronize bank-affiliated enterprises in the hope of improving his chance to obtain it on favourable terms. In antitrust parlance, this is now called ''tying effects'' — to emphasize that the economic effect is just as serious as with overt tying.''[1]

Despite the evident market grip that chartered banks hold in the commercial lending field, the spread of chartered banks into non-banking areas has recently accelerated. The extent of this spread is evident from looking at which banks have interests in what areas.

(1) Donald I. Baker, ''Bank Holding Company Expansion in the Southeast—An Anti-trust Look'', May 28, 1973, p. 25.

The leasing of transportation, communication and production equipment to Canadian business is a relatively new field of bank involvement. Nevertheless, we find that the Bank of Montreal owns 33% of the equity of the Canadian-Dominion Leasing Corporation Ltd., with an agreement to purchase up to 50% over five years, a corporation with assets of $73,645,000 (December 1974) and principally engaged in the business of leasing. The Royal Bank and the Bank Canadian National together own 75.5% of the equity of RoyNat Ltd., a firm with assets of $303,612,000 as of April 1975 and carrying out term financing and equipment leasing. The Royal Bank is also the joint owner, with Marine Midland, of RoyMarine Leasing Ltd., a leasing company with assets estimated at close to $100 million. In a lesser involvement, the Bank of Montreal and the Bank of British Columbia each own 10% of TohCan Ltd., a leasing and finance company with assets of about $15 million. Lastly, United Dominion Corporations (Canada) Ltd., a leasing and mortgage financing firm with assets of $139,918,000 in February 1975 was 49% owned by the Canadian Imperial Bank of Commerce with the remaining 51% belonging to UDT (International) Ltd.

All the chartered banks own an interest in mortgage lending firms. The Bank of Montreal holds a 50% voting interest in First Canadian Investments Ltd., a firm with total assets of $67 million whose investments are restricted to loans to wholly-owned subsidiaries. BNS Mortgage Corporation Ltd. has assets of over $52 million and is restricted to holding NHA and conventional mortgages purchased from the Bank of Nova Scotia. 99.8% of it is owned by Bluenose. Investments Ltd., a corporation in which the Bank of Nova Scotia's voting rights may not be reduced below 50%. The Canadian Imperial Bank of Commerce owns a significant portion of the equity in the Kinross Mortgage Corp. Ltd., whose total assets of $436,633,000 in 1973 made it the largest bank-sponsored mortgage investment firm. As examples of compounded ownership, the Royal Bank of Canada owns 50% of RoyMor Ltd., a mortgage and capital equipment leasing firm with assets of $353,637,000 as of December 1974. The remaining 50% of RoyMor Ltd. is owned by the Interior Trust which in turn is owned 50% by the Royal Bank and 50% by United Bond and Share Limited, resulting in 75% of RoyMor Ltd. being effectively owned by the Royal Bank. In the same fashion, the Bank of British Columbia owns 50% of BBC Mortgage Co. Ltd., with the other 50% being held by BBC Investments of which the Bank of British Columbia again owns 50%. The mortgage investment instrument for the Bank Canadian National is Imnat Ltd., a firm with assets of some $50 million in which the BCN holds 50% of the voting class A shares. Lastly, Scotia Covenants Ltd., with assets of $123,396,000 in 1974 is 100% owned by Scotia Covenants Group Ltd., which is 49.99% owned by the Bank of Nova Scotia.

In the field of Real Estate Investment Trusts (REITs) the Bank of Montreal, the Toronto Dominion Bank and the Bank of British Columbia have their respective direct equity interests as well as management and borrowing relationships. The Toronto Dominion Bank owns only 9.4% of the TDRI (Realty Investments) a REIT with assets of more than $147 million, but it owns 50% of TDRI Ltd., which is the advisor to the REIT. Similarly, the Bank of British Columbia owns only 8.74% of BBC Realty Investors whose assets in1974 were $73,939,000 but it controls it effectively by owning 50% of BBC-RI Ltd., the borrowing conduit for BBC Realty Investors. BM-RT Realty Investments with assets close to $200 million is owned 9.98% by the Bank of Montreal but the Bank of Montreal owns 49.9% of the BM-RT borrowing conduit.

The field of mortgage insurance is closely related to mortgage insurance. Nearly all the chartered banks have invested in mortgage insurance companies up to their allowable legal limit.

Factoring is still another area where bank involvement has noticeably increased since the 1967 Bank Act Revision. By January 1976 The Royal Bank will own of 40% the equity in Aetna Factors Corp. Ltd. — Canada's largest factoring company with assets of $46,723,000. Another manifestation of this trend is the Bank of Nova Scotia's 100% ownership of Scotia Factors Ltd.

Several banks own an interest in mutual funds or mutual funds management subsidiaries. The

Bank of Nova Scotia owns 49.9% of the Scotia Fund Financial Services Ltd. which manages other mutual funds. The Bank Canadian National participates in this market through Canagex Ltd. which manages four mutual funds with total assets of about $25 million. Finally, the Bank of Montreal, through a management agreement, operates the First Canadian Mortgage Fund.

There are also several areas where only one or two banks are presently involved but where the success of these might ultimately attract other banks to these areas. For instance, Telacount Ltd., 49% owned by the Bank of Nova Scotia offers accounting services and also holds the Canadian rights for specialized software and hardware designs enabling small businessmen to connect their touchtone phones to the computer. The Canadian Imperial Bank of Commerce owns 50% of Commerce Optimation Services Ltd. — a firm which prepares input data for computers by the use of large scale optical recognition equipment. The Royal Bank has an interest in a merchant banking operation: the International Capital Corp., Ltd., a firm providing management and financial advice to its customers, and firms in which it has a minority equity interest. The Royal Bank also owns 100% of RoyMark Financial Services Ltd. a consulting firm specializing in corporate finance and mergers and acquisitions.

Finally, it is noteworthy that this discussion of the banks' involvement in "non-bank" areas through subsidiaries excludes the Banks' realty holdings. For example, in the discussion we have ignored the question of whether the Toronto-Dominion's 50% ownership of T-D Centre, a major Toronto commercial complex, or its 33-1/3% interest in Pacific Centre Ltd., a major Vancouver commercial complex, or its 10% interest in A.E. LePage Ltd. a real estate broker, are examples of non-banking activity.

Reflecting upon the present operation of both chartered banks and trust and loan companies we notice trends that differ in direction, extent and origin.

In the case of the trust and loan companies we note a gradual evolution and expansion into personal financial services. The handling of trust and estate business lends itself directly to accepting individuals' savings, to managing or selling real property as an agent, and consequently to making mortgage and even personal loans. This evolution appears logical since estates and trusts generally comprise savings in the form of real property and securities which need to be handled in the best interests of the client. As stated in Chapter II, the History and Development of Trust and Mortgage Loan Companies, the beneficiary of an estate or trust will normally find it more efficient and probably cheaper if he is able to have the properties and securities handled centrally. Trust and loan companies can operate, manage and sell property as agents, extend mortgage facilities, take in savings and at the same time handle all the legal and fiscal complexities associated with an estate or a trust, be it personal or corporate. In brief, it may be said that the evolution of trust and loan company operations to their present level of operations not only follows a logical pattern but has served the public needs in an efficient and economic manner.

Most of the activities which the trust and loan companies have undertaken through subsidiaries and affiliates correspond closely to the statutory objects and powers of the various Trust and Loan Corporations Acts.

A large proportion of subsidiaries and affiliates of trust companies are involved in business pertinent to the handling of mortgages and property management. Consequently many of the subsidiaries are mortgage companies, mortgage insurance companies, real estate corporations and funds dealing with real property holdings. Here again the creation of separate corporate entities has usually resulted from a fiscal or legal necessity.

Canadian trust companies operate trust subsidiaries in foreign countries under separate corporate identities. It may be worth noting that in some cases in Canada the loan company is the parent to the trust company. This does not change the pattern of activities and it can be said that in general, trust and loan companies have closely restricted their activities to correspond with the statutes and their legal intent.

The activities of the chartered banks outside the field of commercial banking proper have increased immeasurably since the last bank act. Under the terms of the 1967 Bank Act, the chartered banks were allowed to enter the mortgage lending market up to a certain percentage of their total assets. Since then, the banks have invested a large proportion of their assets in the mortgage market, and have proceeded one step further by owning interests in mortgage company affiliates and R.E.I.T.'s. These once removed entities may then become outlets for large blocks of mortgages or for mortgages that would cause the percentage of assets invested in mortgages to exceed the allowable maximum. It is difficult to assess whether the syphoning of bank assets into the mortgage market and essentially out of the commercial lending field created undue pressure resulting in higher borrowing cost to industry, but at any rate it is evident that the activities of the chartered banks through ownership, affiliation or minority participation have extended their total mortgage lending activities beyond the statutes and the intent of the Bank Act of 1967.

As an adjunct to their mortgage activities some banks have acquired interests in mortgage insurance corporations. Needless to say, the business of insurance is not a bank related activity and can be economically handled by the firms in that industry. Similarly, interests in firms providing accounting services, software design, real estate agency and mutual funds services are forms of activities which are not related to a commercial banking function. Chartered banks, however, have obviously entered these markets because they feel that activity in these markets will lead to an improvement in the volume and profitability of their banking business. The efforts to develop tying relationships are not acceptable when the services provided are not bank related and also are adequately provided elsewhere

Chartered banks are likely to recommend changes to the Bank Act which will permit them to enter the field of leasing. The irony is subtle since many of the chartered banks have already acquired substantial interests in leasing companies and therefore indirectly do a large volume of leasing.

Since 1967 the chartered banks' interest in real estate has increased beyond the intent of the Bank Act which stipulates that investment in real property should be for the banks' own business use only. Complexes such as the Toronto Dominion Centre and Eaton Centre in downtown Toronto can be considered as major real estate developments that go beyond the business needs of the participating bank. Investments of this sort lead to a misallocation of financial assets within the financial system.

The noticeable trend points to an ever increasing involvement of the chartered banks into diversified markets outside the sphere of banking. Since 1967, chartered banks have decidedly expanded their activities into areas unrelated to banking at an increasing pace and we do not see any likelihood of stemming the tide with the current legislation which defines banking activities by exception only.

The effect anticipated from this continued incursion of banks into unrelated activities can only harm the structure of the financial system and the economy as a whole. There is no doubt and little argument about the fact that the Canadian chartered banks wield substantial economic power which when used to penetrate a market can dominate it and create a complete change within that market. The entrance of banks into a market will not necessarily result in savings to the consumer. Since the banks intend to make their activities profitable and since there is no evidence that they are more efficient, there is consequently no guarantee that the economy will benefit. Chartered banks were allowed to enter the mortgage market gradually after 1967; this was thought to be politically and socially expedient since demand pressures for mortgage money were real at that time. At the same time, however, banks entered the long-term fund market. This resulted in strong competition for long-term savings, much of its at the expense of those intermediaries who depend on long term funds for mortgage lending. It may therefore be that the banks' simultaneous

entrance into the mortgage market and into the long-term savings market had a neutral if not a negative effect on mortgage costs. Furthermore, the reallocation of their financial assets into the more profitable and secure mortgage market created a contraction of funds available for commercial loans, for industry, trade and economic development.

The most alarming aspect of the banks' diversification is in the seemingly innocuous argument often used by the chartered banks to justify undertaking non-banking business. Briefly stated, the chartered banks claim that they have the physical facilities, the geographical marketing penetration and the soundness that makes them the logical distributors of any financial services to the community and the economy. This is undoubtedly the argument which they will use to request access to leasing power. This argument is dangerous but explicit: it is a reflection on the nature and strength of the competition. If a better financial system is to be built then it is not the banks who should be encouraged to absorb more and more of the financial system, but rather, other intermediaries who should be provided with better means to service non-banking financial markets more aggressively.

Most Canadian chartered banks are importantly involved in foreign markets, competing actively on international markets. To remain competitive and profitable they must have the necessary competence and financial strength. This is a fact and some banks have subtly claimed that their domestic expansion has enabled them to become strong international entities. We do not deny that in international banking financial power is important but we do not see how the conversion of the banks domestic activities into a financial supermarket bears any relationship to their ability to remain competitive internationally; nor do we anticipate that the Canadian economy should for all intents and purposes subsidize the Canadian banks' international competitive position through a form of domestic monopoly over financial assets and services.

C. Indirect Expansion by Banks

The analysis of banking by function has led us to indicate what we believe to be the proper uses of funds by the chartered banks. If their activities are restricted to those relating specifically to the banking functions, there is a distinct possibility that their assets and financial resources may be under-employed, particularly in a transitional period.

Substantial concern has been expressed about their incursion into non-banking areas, and we have provided examples of their doing indirectly what they are unable to do directly. We see the possibility of their requesting the power to establish the equivalent of the U.S. banking holding company, which would enable them to penetrate other market areas, regardless of restrictions on direct investment in the equity of other companies, joint ventures or subsidiaries. We suggest that the conglomerate nature of U.S. bank holding companies, the concentration of influence, and the effects of a two-profit possibility all militate against any relaxation in this direction.

Ownership of equity in other companies is a feature of merchant banking, not of a type of institution that accepts deposits from the public, respects the monetary function, and whose primary purpose is to be a neutral intermediary. The structure and organization of successful merchant banks have evolved in the U.K. and the U.S. to deploy higher risk funds in anticipation of economic benefit through ownership. Traditionally, merchant banks have been tightly knit organizations, in which each executive has had wide discretionary powers in his area of specialization. We suggest that the checks and balances required for the proper organization of a public deposit-taking institution is ill-suited for success in this field. This being the case, the chartered banks should be closely restricted in their ownership of equity in other companies.

Bank expansion is a real and difficult economic and social problem, for greater and completely different reasons from that of the trust and loan companies. Unless we are willing to lose control of the remnants of a competitive element in our financial system, the chartered banks' activities must be contained within the concept of banking. This will only be done through a precise legal definition of banking which itemizes the intermediaries' allowed activities.

D. Conclusions

1. Banks have expanded beyond the spirit of the mandate given in the 1967 revisions.
2. Trust and loan companies have been following a logical extension of developed capacity.
3. Banks have moved into other markets not by virtue of a relationship to banking activities but either through
   a) motivations of higher expected profitability
   b) the passive acceptance by government authorities that when a vacuum needs to be filled the banks' market and financial strengths are powerful qualities which no one else can match in the financial markets.
4. The permissive attitude towards banks' expansion into unrelated activities endangers the competitive potential of other smaller but equally efficient intermediaries and in the long-run threatens to bring the chartered banks into a monopoly position within the financial system.
5. A functional restructuring of the financial system can be achieved through a proper definition of banking which allows chartered banks to concentrate their economic powers in proper banking activities.

IV ISSUES OF GENERAL CONCERN

In this section we will be commenting on issues which will probably be raised in the forthcoming review of the Bank Act. As we have adopted a certain view of the financial system we will be considering separate issues within that overall context as well as on their particular merits. We shall deal first with issues of general concern, namely those items that are not specific to one instrument or one market aspect but which affect the financial system in general.

The first issue discusses the arguments for and against bringing the trust and loan industry, among others, under the umbrella of the central banking authority. The second issue anticipates the importance of development in the electronic transfer media and its attendant effects on the financial system and its participants. The last issue deals with the problems attached to the current nature and structure of the long term borrowing markets and the respective roles of financial institutions involved in it.

1. TRUST AND LOAN COMPANIES AND RESERVE REQUIREMENTS

A. Introduction:

The Canadian chartered banks, who make up the largest segment of the financial system in Canada, are subject to the reserve requirements of the Bank of Canada. Other financial intermediaries are not. Finance companies, loan companies, trust companies, credit unions, caisses populaires, cooperatives and Quebec savings banks are regulated and controlled by their own particular legislation or not at all. The growth of these intermediaries within the financial system has led to the suggestion that a form of monetary control should be applied in a standardized fashion to all financial institutions.

B. The Issues:

The issues involved in a discussion of reserve requirements as it pertains to trust and loan companies are perceived differently by each of three interested parties: the Bank of Canada, the chartered banks and the trust and loan companies themselves. Each party has different objectives and motives:

i. Central Bank Concerns

On a national policy level, the most important issues are those raised by the central banking authorities. Under the existing system, the Bank of Canada lacks any direct control over a substantial segment of Canadian financial assets. Some claim that this situation weakens the effectiveness of monetary policy.

There are two arguments regarding monetary control through central banking, the academic and the practical.

a) **Academic Arguments:** The argument that non-bank financial intermediaries can create credit and operate in contravention of monetary policy was first raised in academic journals by J. Gurley & E. Shaw.[1] They claimed that the indirectly financed proportion of Gross National Product has risen with the relative gainers being the non-bank financial intermediaries. That is, given that the monetary system determines the supply of money, and given that chartered banks transfer to investors that part of the money supply deposited by savers but not set aside to meet reserve requirements, a loss of assets to the chartered banks may result from the transfer to investors of that part of the money supply deposited with the non-bank financial intermediaries. If this premise is accepted, then the resulting financial competition may inhibit the growth of the monetary system since a gain in attractiveness of the instrument of a non-bank financial intermediary vis-à-vis demand deposits, or money balances, will result in an excess supply of money.

Thus, at any level of income, competition from non-bank financial intermediaries may displace money balances, shift primary securities from the banks to their competitors and reduce the monetary system's requirement for reserves. The above summarizes the Gurley-Shaw argument which hypothesizes that the presence of non-bank financial intermediaries that do not belong to the reserve system render monetary policy less effective and less efficient.

The counter argument, developed principally by J. M. Culbertson, rejects this hypothesis on the basis that non-bank financial intermediaries' deposits are rapidly recirculated into the demand deposits of the banking system. The presence of near banks introduces a competitive element into the financial system which is not directly controlled by the central bank. The academic arguments still await scientific proof, while each side presents contradictory evidence based on differing premises or statistics.

(1) J. Gurley & E. Shaw: **Money in a Theory of Finance.** Brookings Institute, Washington, 1960.

b) **Practical Concerns:** The practical concern of a central banking authority stands on much simpler grounds: the extension of some form of control of information to all financial institutions involved in the country's capital markets may be a better decision-making guide.

Firstly, supervision by the central bank over all financial institutions could improve the timing and quality of monetary policy. An important adjunct of a centralized finance system is the flow of information required from institutions subscribing to a central banking system. Each participating institution would submit standardized data on a regular basis. Although this may comprise an additional paper work burden on many financial institutions it provides certain advantages: it feeds the central banking authority with a steady flow of standardized information from all sources. This flow of information would be an improvement over the present one and would therefore enable the central bank to have a clearer perspective of financial variables within which to set monetary policy. Also at the present time not all financial institutions report regularly and when they do, such reports are not comparable with those the chartered banks who maintain daily records and report weekly. Communications therefore would improve.

Secondly, the central bank is concerned with the stability of the system itself and of all its component parts. The concept of monetary reserves of the chartered banks held by a central agency originated with the knowledge that the liabilities of banks, under certain circumstances, may become volatile whereas its assets are less liquid. The calling in of loans is generally a lengthier process that the cashing of demand deposits held by the public. A certain percentage of asset portfolios should therefore be held liquid and subject to control. The concept of monetary policy evolved from the economic effects observed as a result of changes in reserve requirements.

The argument that an extension of reserve requirements to the entire financial system will create additional liquidity only applies if new member institutions do not have their own regulations for liquidity requirements operating outside the Bank of Canada. Some foreign owned and domestic financial institutions have no legislated liquidity requirements and resulting low levels may lead to situations of illiquidity which can severely disrupt the financial system and shake the confidence of depositors and investors.

Thus, there is no doubt that bringing unregulated institutions under some form of regulation will improve the liquidity and the stability of the system. On the other hand, switching from one form of regulation to a central finance system by institutions that are already regulated may not necessarily achieve either greater stability or greater liquidity for the system as a whole. The validity of extending monetary control only applies to unregulated financial institutions.

ii. Chartered Banks' Concerns

The chartered banks are principally concerned with competition within the financial markets. Chartered banks claim that under the existing system, they alone have to comply with the reserve requirements of the Bank of Canada although their market is no longer protected. Other financial institutions are exempt from compliance and compete for deposits and loans more and more strongly. Since these institutions do not incur the cost attached to having non-earning assets with the Bank of Canada, they apparently benefit from a competitive advantage. This argument is only partially valid, since most financial institutions operating in Canada have some form of liquidity requirement. This imposition constitutes an opportunity cost which varies in degree depending upon the relationship betwen short and long term yields. Traditionally, the chartered banks' average cost of money has been lower than that of other financial institutions which gives them a fundamental competitive advantage.

The argument makes some sense when viewed in the perspective of the intrusion of foreign bank affiliates and their marginal cost of money. They benefit from the guarantees of their parents to support their liabilities and thereby reduce their cost of funds. In some cases the cost reduction may be significant enough that their cost of money at the margin may equal or better that of the

chartered banks who have to comply with reserve requirements. Furthermore, some have attained a ratio of liabilities to paid in capital of two hundred to one. These situations justify the attitude of chartered banks vis-à-vis institutions that are essentially unregulated, and no doubt liquidity requirements are needed to ensure stability. The application of central bank control to either the foreign bank affiliates or to financial institutions which lie outside the central bank's sphere of authority, but are regulated to ensure satisfactory liquidity, is in no sense a logical necessity.

The chartered banks may also argue peripherally that the existence of some institutions whose liquidity levels are uncontrolled creates potential instability of the financial system. A failure by any of the members of the system reflects on all the other members and therefore there is a true cost associated with the potential risk. In fact, the failure of a non-bank financial intermediary may reflect favourably on the reputation and the activities of the banks at the expense of non-bank financial institutions.

In conclusion, the chartered banks' position on reserve requirements is only defensible as it pertains to the control of foreign bank affiliates and other financial institutions that do not have regulated liquidity levels. In the case of institutions such as the trust and loan companies, it is defensible neither on the grounds of competition nor liquidity. In addition to this, chartered banks, by membership in the central bank's network, benefit by receiving the substantial demand deposits of the Government at the transactions cost associated with these deposits. The Government's increasing economic role can only mean that these funds will remain within the banking system alone. Government demand deposits constitute a vast and steady source of funds. The banks currently claim that the benefits associated with the availability of these deposits are outweighed by the cost of the transactions and processing which they have to absorb. It appears, however, that with the development of a sophisticated electronic transfer system, processing costs would be reduced to a level which would render government business attractive. Belonging to a centralized finance system may well in future bring benefits to the members which will offset the costs.

iii. Trust and Loan Company Concerns

Trust and loan companies see "reserve" requirements in different terms from those of either the central banking authority of the chartered banks. Under the terms of the applicable legislation, the standards of liquidity for trust and loan corporations are uniformly regulated by federal or provincial acts.

Liquidity standards have been rendered uniform even though individual companies remain subject to their various provincial or federal jurisdictional requirements, depending on the method of incorporation. As a typical example of liquidity requirements, under the terms of the Loan and Trust Corporations Act of Ontario, all trust and loan corporations must maintain segregated assets in the form of cash, bank deposits and certain specific securities equal to 20% of demand deposits and debt maturing within 100 days. As an alternative, with express approval only, the corporation may establish lines of credit from Canadian chartered banks.

The restrictions on the composition of the liquidity in question are such that at least 25% must be in cash, bank deposits or securities of, or guaranteed by, the Government of Canada, with maturities of three years or less. Furthermore, at least 50% of the segregated assets must consist of cash, bank deposits or securities of or guaranteed by the Government of Canada with maturities of ten years or less. The balance of segregated assets may be made up of securities of, or guaranteed by, any province of Canada.

The liquidity requirements imposed on trust and loan companies are such that all their components earn interest, unless use is made of lines of credit.

At this point, it is important to differentiate the financial functions of trust and loan companies.

Loan and trust companies are apt to be lumped together in legislative nomenclature, in regulatory affairs and in operation and ownership. Under "the basket clause", trust companies have the right to make consumer and term loans and in exercising these powers, a very small portion of their activities resemble the credit creating functions of the banks. The liquidity requirements established for mortgage loan companies are not related to a credit creating function but ensure that these organizations are in a position to meet their maturing debt obligations as they occur. Different functions justify different treatments, which seems to support the argument that different reserves or liquidity requirements are justifiable for institutions with differing economic functions.

There have been very few failures of trust companies over the past decade and problems have been due not to the inadequacies of liquidity levels but to business practices which could not have been overcome by changing liquidity requirements.

The argument that follows, namely that a centralized finance system with a uniform reserve system for all institutions would add stability by supplying all financial intermediaries with a lender of last resort, is inappropriate when applied to trust and loan companies.

a) **Lender of Last Resort Argument:** In 1967 the Government of Canada introduced its Canada Deposit Insurance Corporation (CDIC), and the Quebec Deposit Insurance Board (QDIB) was formed subsequently. These institutions are designed to protect depositors against loss through bankruptcy or insolvency of certain finacial institutions that solicit deposits from the general public. By offering deposit insurance, the insuring government institution is often able to exercise a degree of supervision over financial institutions that might not be otherwise possible.

The Canada Deposit Insurance Corporation provides insurance up to $20,000 per depositor on deposits with a member financial institutions. All federally incorporated private financial institutions that take deposits must be covered by insurance, which includes chartered banks, Quebec savings banks, an many trust and mortgage loan companies. Provincial trust and loan companies may apply for membership in the Canada Deposit Insurance Corporation if the province of incorporation consents. The term "deposit" is interpreted broadly for insurance purposes and includes not only deposits, but also deposit receipts, certificates and debentures (excluding chartered banks debentures) involving money payable on demand or notice or on a fixed date not more than five years after the money is received. Deposits payable outside Canada or in foreign currency cannot be insured.

The Canada Deposit Insurance Corporation has the power to act as a lender of last resort to its member institutions. By statute, it can obtain up to $500 million from the Federal Government for making loans to members that are in temporary financial difficulties and unable to obtain funds elsewhere. The chartered banks and money market dealers have lender of last resort facilities at the Bank of Canada and all institutions making N.H.A. mortgage loans can use such mortgages as collateral for obtaining temporary funds from the Central Mortgage and Housing Corporation.

In addition, for institutions operating in the province of Quebec, the Quebec Deposit Insurance Board insures deposits up to $20,000. It may make advances up to $250 million to member institutions with funds obtained from the Quebec Government and it may receive loans of up to one year from the Canada Deposit Insurance Corporation against sufficient security.

Thus, with the emergence of the Canada Deposit Insurance Corporation and other deposit insurance institutions, lender of last resort facilities have become more readily available in the Canadian capital market and a line of credit with the Bank of Canada less meaningful.

In the specific instance of trust and loan companies, the advent of the Federal Mortgage Exchange Corporation will enable them to market their mortgages and therefore realize whatever

level of liquidity may be necessary or desired. For companies facing temporary financial difficulties this will provide an alternative to the requirements for a lender of last resort and thus diminish the risk to the industry as a whole. If there were any validity in the lender of last resort argument, then, as a corollary to membership in a centralized reserve system, trust and loan companies would presumably be granted access to the full privileges of the reserve system members and their investment constraints relaxed in accordance with the diminished risk.

If trust and loan companies were extended reserve membership privileges they would qualify to receive Government demand deposits. This would provide them with an additional liability base, the incremental volume being determined by the Bank of Canada.

So far, we have summarized the issues from several viewpoints without approaching the way in which the problem may be resolved. As is seen in the following section there are several solutions to this problem.

iv. The Available Choices:

We anticipate pressures to include all financial institutions operating in Canada under some form of control, with immediate emphasis on the regulation of foreign intermediaries presently operating in Canada outside the direct control of the central bank. This concern is justified by the fact that these foreign financial institutions now control a substantial an growing portion of Canadian financial assets.

With this in mind, we assume that the present system is unlikely to stand unchanged over the long term and we will concentrate on possible changes that may be brought into the financial system in Canada over the next decade. We outline the main possibilities below:

a) **Standardization** — This implies that all financial institutions will be brought into a common reserve requirement system, presumably the one existing for chartered banks. The current reserve requirement requires chartered banks to maintain in cash or deposits with the Bank of Canada 12% of their Canadian demand deposits plus 4% of their Canadian notice deposits. In addition, they must maintain secondary reserves, currently amounting to 5.5% of the banks' demand deposits in interest bearing treasury bills and day loans.

The concept of standardization would extend this structure of reserve requirements to all institutions taking deposits on demand or notice in Canada.

b) **Extension** — This concept presumes only that liquidity and monetary control should be centralized and applied to all financial intermediaries operating in Canada. It differs from standardization in contending that different controls for different types of institutions can and should be established under the umbrella of centralized monetary control. Although current reserve requirements applied to banks may be appropriate for banking institutions, liquidity and control objectives may be achieved equally well for other institutions through a different standard.

Since we are concerned with trust and loan companies, the ensuing possibilities will be compared with the existing system of liquidity requirements for that industry. Standardization implies only one combination; extension comprises several, the main ones being outlined below. It will be seen that neither the public nor national interest will be better served by their introduction.

— Primary reserve only to be deposited with the Bank of Canada or held in cash to an amount equivalent to 4% of all deposits, comprising demand and term deposits, regardless of maturities. This would be logical only if the central banking authorities consider all deposits with trust companies to be "in trust" and therefore conceptually closer to notice deposits than to demand deposits.

— Primary reserve of 12% restricted to all deposits not requiring notice, to be held in cash or deposit with the Bank of Canada. The principle applied here brings all chequable or demand type deposits under the umbrella of monetary control.

— Secondary reserve requirements only, by way of a certain percentage of total deposits, currently 5.5% held by the institutions in the form of specified interest bearing financial instruments. The logic behind this possibility is that it resembles the current liquidity mechanism regulating trust and loan companies.

— A special requirement which is tailored exactly to the needs of the trust and loan companies but which nevertheless satisfies the liquidity and control needs of the Bank of Canada. There are numerous possibilities under this heading, although we feel that variations are not likely to differ substantially in terms of their concept or consequences from the ones outlined above. We consider therefore that a proper view of the consequences of implementing any of the previous options will provide a satisfactory perspective of the possible range of outcomes.

v. Implications:

The implications stemming from any one of the previous choices will be discussed below. They can be reviewed under three major categories: the jurisdictional, the macro-economic and the micro-economic.

a) Jurisdictional implications: Under the present system, trust and loan company operations are controlled provincially or federally, depending upon where the individual firm is incorporated, where it operates and who is responsible for the inspection function. On the other hand, all chartered banks are federally controlled by virtue of a single act, the Bank Act.

Presently, trust companies are major financial institutions under Provincial jurisdiction. Considering the existing relationship between the Provinces and the Federal Government, it is difficult to imagine that Provincial Governments would voluntarily relinquish their direct control over this substantial pool of financial assets. To illustrate this, one province has even intimated at the possibility of legislation to enforce greater investment of the trust companies' assets in the province.

Thus, the major implication of a centralized financial system is that the Provinces may lose much of their control over the intermediary function of trust companies and consequently would resist this. If the Provinces were to opt for a central system they would do so reluctantly, on a restricted basis, and certainly in exchange for other powers.

The problem of uniform jurisdiction is therefore an important aspect which would have to be resolved before a centralized financial system could be implemented over all financial institutions in Canada. The jurisdictional problem is common to any of the possibilities delineated above. Standardization implies the greatest displacement of Provincial jurisdiction by a Federal body whilst some form of compromised control or a weak extension of centralized finance may be a lesser incursion on Provincial jurisdiction.

The worst possible situation would be one in which both the Federal and the Provincial Governments enter into a tug of war leading to a duplication of reserves and liquidity requirements. Needless to say, subjecting the trust and loan companies to two separate systems, one Provincial and one Federal, would be inequitable and economically inefficient.

b) Macro-economic implications: Under this heading we will consider economic implications for the country as a whole as well as for the Canadian financial system.

The choices listed above from standardization to the various forms of extension represent various degrees of asset mobilization. Standardization applied to all financial institutions would transfer a substantial increment of financial assets into the reserve system from the newly joining institutions. In the case of the trust and loan companies, these assets are currently held in productive, interest bearing savings instruments. The economic cost of monetary control is a result of primary reserve assets being held in cash and not re-entering the productive borrowing-lending cycle. The social cost of centralized finance is reduced as one moves from standardization to extension in its various forms. The secondary reserve proposal may preserve the advantages of centralized control while avoiding an incremental cost to the trust and loan companies.

In the aggregate, for all financial institutions newly subjected to reserve requirements of some sort, there will be a shift into more liquid assets earning a lower revenue. (See Table XXIV) This aggregate portfolio shift will have an effect on the general structure of financial assets. For trust and loan companies it may well constrict the flow of funds going into the mortgage market and bring about an undesirable social and economic cost. In the case of financial institutions which presently operate in Canada uncontrolled, the imposition of reserves may result in a net benefit to the economic system.

The thrust of any effort to absorb all institutions under one umbrella must be principally aimed at foreign bank subsidiaries operating in Canada and other financial institutions whose activities have become substantial but are not under any form of control. The total cost of incremental liquidity in an already severely pressed financial system is only justifiable if the new centralized system will result in an improved monetary policy and consequently a healthier economy. If trust and loan companies are the only additions to be made to the centralized system then clearly the costs outweighs the benefits. In the event that foreign bank subsidiaries were the only additions to centralized control, the benefits may equal the costs for the system as a whole.

Lastly, equity problems will arise if identical reserve requirements are applied to financial institutions requiring all of them to hold the same percentage of non-earning assets based on a completely different set of liabilities. These different liabilities traditionally have corresponded to a different set of assets.

The equity questions raised therefore are as follows: Is it possible to alter the asset structure of some financial intermediaries and not expect a change in their liability structure? Is it not likely that changes in the asset and liability structures will change the earning performances of trust and loan companies?

In summary, by bringing all financial institutions under a common umbrella the cost of carrying out dissimilar lines of business would be equalized, probably at the expense of all financial institutions other than the chartered banks, because of the banks' fundamentally lower cost of money. Thus, although a uniform reserve requirement system will equalize the cost of carrying out dissimilar types of financial business, it will, **ceteris paribus,** reduce the earnings of non-bank financial intermediaries by subjecting them to an incremental cost without an incremental revenue. The contradiction which therefore appears is that the imposition of a reserve requirement will reduce the return on investment of non-bank financial intermediaries and consequently both increase their cost of raising capital and make it more difficult to attract. At a time when an increased level of competition is deemed necessary to counteract the expansion of the banking sector, nothing could be more deleterious to the financial system than to reduce the profitability of non-bank financial intermediaries and concurrently their ability to compete by attracting expansion capital.

c) **Micro-economic implications:** The micro-economic effects are those which affect the firm specifically as opposed to the economic system as a whole. With respect to trust and loan companies, if we assume that centralized control were imposed in any form listed previously, the individual cost to each of the companies will vary.

Portfolio Structure:

The impact depends not only on the alternative form of reserve chosen, but on the individual company's portfolio structure.

Currently, a company with a higher proportion of its assets in short term maturities will incur a higher liquidity cost by having more liabilities coming due within 100 days. Thus, one of the basic differences in cost of liquidity requirement to different firms is their individual portfolio structure. Undoubtedly, if a reserve requirement were imposed, portfolio adjustments would take place to attempt to minimize the cost to the individual firm, though such changes would not necessarily be in the public or national interest.

Form of Reserve Requirement:

As we have said different firms in the industry would incur different costs depending on the composition of their portfolios. The most critical aspect for the firm, however, remains the type of reserve requirements imposed. We have previously outlined the major possibilities and it now becomes vital to consider the magnitude of the impact on the industry.

We refer to the example provided (see Table XXIV) which is based on December 1973 figures supplied for Ontario registered trust and loan companies.[1] 1973 was the year in which the profitability of trust and loan companies combined was the highest since 1967.

In terms of cost, the most expensive proposition is the imposition of the same reserve requirement on trust and loan companies as presently exist for chartered banks.

Under existing liquidity requirements, at that time, trust and loan companies were required to hold a minimum of $201.6 million in cash, bank, deposits or short term Government interest bearing securities. In fact, they held $321.0 million, the excess liquidity corresponding to business expectations or judgement at that time. Since $201.6 million is the actual minimum it is a better benchmark to evaluate the effect of substituting a reserve requirements identical to that of the chartered banks.

The standardization approach would have required trust and loan companies to maintain $216 million in non earning deposits with the Bank of Canada, plus another $221.3 million in secondary reserves. Secondary reserves of the Bank of Canada are treasury bills and day loans which traditionally yield marginally lower returns than other securities allowable under the Ontario Act. The net effect would be $437.3 million in total reserves, an increase of $235.7 over the present minimum, of which $216 million would be non revenue earning and $221.3 million would be made up of lower yielding securities.

In our example, with the imposition of a primary reserve requirements the trust and loan companies would have to set aside $216 million in the form of non earning deposits with the Bank of Canada. Assuming that these funds would be withdrawn from the current short term paper which makes up the trust and loan companies' liquidity requirements there would be a loss of revenue equivalent to the income earned on the average on these short term securities. The return earned by Ontario registered loan and trust companies on their bonds and debentures on the average in the year 1973 was 6.4%.[2] The anticipated loss would consequently amount to approximately $13.8 million before taxes thereby reducing the total before tax profit of these companies from $60.8 million for that year to $47.0 million.

(1) Registrar's Report. **Ontario Loan & Trust Companies.** 1973, p. 332.
(2) Source: Canadian Bankers' Association, 1974.

The percentage decline in earnings due solely to the primary reserve requirements amounts to a 23% drop. During 1973, the return on equity for the trust and loan industry amounted to 10.83% and consequently the imposition of primary reserve requirements would reduce this return to 8.34% net after tax.

If trust and loan companies were forced to maintain secondary reserves amounting to $221.3 million in addition to the primary requirements, they would lose an additional 1.07% of revenue on that amount. The 1.07% represents the difference between the 6.40% average pre-tax return earned by the trust and loan companies on their "liquidity requirement" portfolio and the chartered banks' average pre-tax return on their secondary reserves for that year of 5.33%.[1] This reduces after-tax income by an additional $1.2 million.[2] The total effect would be to bring the industry's net return on equity in that year down from 10.83% to less than 8%. We stress that the above example is not intended to fix the cost, but only to indicate a quantum based on rate structures at a particular point in time.

The reduction in return on equity shown in this example appears even more dramatic if we consider the relative position of trust and loan companies vis-à-vis other financial institutions. Suffice it to say that the corresponding net return on equity of chartered banks for the same period was estimated at 14.88%. With primary and secondary reserve requirements being imposed on trust and loan companies, chartered banks' net return on equity would be even higher on a relative basis.

Considering the lower historical profitability of trust and loan companies relative to banks, it is clear that imposition of similar reserve requirements with no offsetting tangible benefits would further reduce their profitability. Since the profitability of an industry is a key factor in its ability to raise capital for expansion, the imposition of primary and secondary reserve requirements would put trust and loan companies at a further disadvantage relative to chartered banks. The imposition of reserve requirements of this form would consequently hamper the trust and loan industry in its ability to raise additional capital for expansion. This constraint would severely restrict the amount of competition that the trust and loan companies can provide other financial institutions.

If an increased degree of competition is an objective in the restructuring of financial markets in Canada, then the contenders must be placed on the same footing. Increased reserve requirements can only diminish competition and the growth of the trust and loan companies as a viable alternative to chartered banks.

If primary and secondary reserves were to be imposed on the trust and loan industry, it is also expected that the individual companies would attempt to move back up towards an adequate margin of profit. Since the vast majority of their portfolio consists of mortgages and since the industry will not survive or grow on such a low return on equity, it would necessarily resort to increase its operating spread and consequently increase the mortgage rate. The social effect inherent in this adjustment may well exceed any benefits derived from the imposition of reserve requirements equivalent to those imposed on chartered banks.

The cost of the extension approach varies with the level of reserves required and with the liability definition that the central bank wishes to adopt. For example, it may be considered that all demand deposits with the trust and loan companies are equivalent to the chequable savings deposits of chartered banks with requirements of 4%. On the other hand, term loans such as G.I.C's may be excluded from reserve liabilities, or a 12% requirement may be placed on all so-called deposit liabilities.

(1) Assuming a 50% corporate tax rate

There are many variations within the central bank's purview. The choice will be based on the central bank's guiding objectives: if its prime concern were to maintain the safety of financial institutions as a whole it would rely on a different type of reserve requirement from that which would be most effective in influencing monetary policy. In the latter case, for example, it would pull on strings that affect short term monetary flows rather than overall savings.

The cost of any one of the options to extend reserve requirements will be less than the cost of the current system as applied to the banking system. They will all, however, reduce revenue, lower return on equity and consequently hinder trust and loan companies' ability to raise capital since they all imply holding assets in the form of non-income-earning deposits with the Bank of Canada.

The imposition ofsecondary reserve requirements only on trust and loan companies is worth examining. Secondary reserve requirements of 5.5% are currently imposed on total deposit liabilities of chartered banks. In our example, if trust and loan companies came under the same restrictions, they would have to invest 5.5% of $4,009 million or $221.3 million in treasury bills and day loans. The cost would therefore be as follows. Firstly the trust and loan companies would have to place an additional $20 million in reserves, based on the current minimum of $201.6 as required by legislation. Secondly, they would be earning a lower return on these assets: the average return earned by Ontario registered loan and trust companies on their bonds and debentures in 1973 was 6.40%[1] while the chartered banks' return on their secondary reserve was 5.33%[2] or a decrease slightly in excess of one per cent. The differential cost consequently represents at least one percent of $221.3 million (based on one percent of $201.1 million, plus probably slightly more on the extra $20 million required). Net after tax cost in our example could be as much as $1.2 million dollars.

An additional problem must be considered, however, since under the present legislation, liquidity requirements vary for each company only on the basis of their portfolio maturity schedule, whereas under a central bank they would vary with monetary policy. Therefore, even though the present secondary reserve level of 5.5% does not appear to be much more costly than the current trust and loan companies' liquidity requirement, a quantum jump from 5.5% to 6% or more would be very expensive to the industry. We cannot assume that secondary reserves will remain stable at 5.5%, consequently the industry must take into account that being subjected to secondary reserve requirements may be much more costly than is represented in our example.

vi. Conclusions:

1. Proponents of a centralized finance system argue in favour of extending reserve requirements or their equivalent to all financial intermediaries, including trust and loan companies, to accomplish the following objectives:

— Maintain adequate liquidity to meet calls on the financial system.

— Improve the effectiveness of monetary policy by extending control to institutions presently outside the Bank of Canada's direct jurisdiction.

— Improve the data base on which monetary policy is based.

— Improve stability by providing lender of last resort facilities.

2. We have examined the most probable methods of standardizing or extending reserves or their equivalents to financial institutions other than chartered banks, and conclude:

(1) Registrar's Report, **Ontario Loan & Trust Companies.** 1973. p. 332.

(2) Average return earned on secondary reserves by banks in 1973. **Canadian Bankers Association.**

— With respect to the Canadian subsidiaries of foreign banks, the imposition of liquidity requirements, but not necessarily reserve requirements, would be beneficial. Existing regulations are adequate to enforce a satisfactory level of liquidity within the trust and loan industry.

— Any form of standardization or extension of the central bank's reserve system will involve substantial costs to trust and loan companies. Since we have demonstrated that no improvement in the effectiveness of monetary policy would result, the attendant damage to the trust and loan industry would be unjustifiable.

— Provisions of better information can be secured by other means.

— Broad lender of last resort facilities already exist for trust and loan companies.

TABLE XXIV
COMPARATIVE RESERVE AND LIQUIDITY REQUIREMENTS UNDER CENTRAL AND ONTARIO REGULATIONS(1)

		Central Bank Reserve System			Ontario Act Liquidity Requirements
		Primary		Secondary	
QUALIFYING LIABILITIES		4%	12%	5.5%	20%
Total Deposits ($ millions)	4,009	—	—	221.3%	—
Demand Deposits ($ millions)	695	—	83.4	—	—
Term Deposits ($ millions)	3,314	132.6	—	—	—
Maturing Within 100 days ($ millions)	1,008	—	—	—	201.6
Total Primary ($ millions)		216.0		—	—
Total Secondary ($ millions)		—		221.3	—
Total Reserves ($ millions)			437.3		201.6(2)

(1) Based on figures obtained from a representative sample of firms. The Registrar of Trust and Loan Corporations, Ontario, 1973.

(2) These represent minimum required liquidity levels, actual liquidity at that date was $321.0 million.

2. ELECTRONIC FUNDS TRANSFER SYSTEM

A. The Issue:

The advent of automated electronic payment systems requires the trust and loan industry to examine the effects of the systems on the industry and its own possible roles and function within the systems. Trust and loan companies therefore wish to state their position so that they may be properly integrated when an Electronic Funds Transfer System (E.F.T.S.) reaches the implementation stage.

B. Background:

In April 1973, the Federal Government published a "Green Paper" indicating its "current perception of a viable computer/communication policy that will enable Canadians to derive maximum benefit from computer/ communications services". That paper led to the establishment of a number of working groups and a further paper entitled "Towards an Electronic Payments System" which states the intent as follows:

> "Recognizing the critical and pervasive role of financial institutions in the functioning of the economy, it is very important that, in the rapid evolution of computer/communications involving the payments system of the nation and other financial services, a competitive environment should be maintained and that developments be consistent with the general policies outlined herein."

Efficiency of the payments system relates directly to the efficiency of the economy. Currently, our payment system relies almost entirely on the transferable deposit or cheque system, "if the word cheque is taken to mean payment instruments drawn not only on the chartered banks but on other deposit taking institutions as well, including trust and mortgage loan companies, credit unions, caisses populaires and provincial government savings institutions. This system also includes legal and procedural arrangements among deposit taking institutions that provide for the quick and reliable transfer of cheques, for the accurate entry of the resulting debits and credits to individual accounts, and for the final settlement of amounts due between deposit taking institutions.

The government has an interest in the payments system not only because it is essential for normal economic activity but also because the structure of the payments system effects the competitive convenience and consumer rights."

The government has stated the objectives of a payment system as follows; it should be:

— equitable between deposit taking institutions and among their customers;

— efficient in terms of cost;

— competitive with respect to payment services offered;

— secure against fraud and invasion of privacy.

Development of E.F.T.S. will comprise several areas of activity. The most widely recognized and the first one to be implemented will be the automatic payroll system: companies submit a magnetic tape record of their payroll to the deposit taking financial institution of their choice which sorts out the records of employees with accounts in that institution, crediting their accounts, and then sends the balance of the payroll information by wire or tape to an Automated Clearing House (A.C.H.) which sorts and switches the information to other deposit taking institutions where employees have their accounts. This form of application is the most practical and the easiest to implement given our present level of technology. The Federal Government, for example, could process a volume of over 105 million cheques electronically without the mailing and paper costs. Payments covered would include family allowances, old age security, income tax refunds, public service payroll, etc. Provincial and municipal governments would benefit similarly from the automation.

The second step comprises the system of multi-payment cheques, whereby the deposit taking institution allows its customers to pay most of their monthly bills by listing multiple payees on a single cheque. The multi-cheque is processed through the A.C.H. which distributes the credits to the proper banks, eliminating the paper work. At the same time, deposit taking institutions will institute an automatic bill payment mechanism, ideally suited to making recurring payments such as mortgages or leases.

Both of these applications involve large volume, batched transactions which are pre-arranged, by agreement, between an individual and an organization such as a company or branch of Government. The time required to process the transactions is generally in terms of days or at least hours. The initial agreements will be between the clearing houses and the organizations and follow the traditional lines of business relationships between industry and Government, on the one hand and the chartered banks on the other. Existing technology and equipment can handle these applications and Non Bank Financial Intermediaries (N.B.F.I.'s) should find it relatively easy to offer these services to their individual depositors through arrangements with the A.C.H.'s.

E.F.T.S. will, however, be developed for a different kind of "payment" in future. These are the spontaneous, depositor-originated transactions made at bank branches, at automatic banking terminals located away from manned branches, and at sales transaction terminals located at the point of sale. Such systems would enable individuals, through the use of magnetically encoded plastic cards, to make deposits and withdrawals, transfer funds between accounts and pay bills directly through electronic terminals. Similarly, point-of-sale (P.O.S.), terminals would enable an individual to pay for a purchase immediately through transfer of funds from a deposit account or credit facility to the merchant's account. These become "cash" transactions without cash, eliminating the need for billing, cheque issuing and clearing, and mailing. Implementation of this type of "on -line" system will be both complex and costly. A great deal of expensive terminal, communications and computer equipment and software will be required including security devices and control mechanisms to prevent error or fraud.

A key to the "on-line" E.F.T.S. systems will be the development of regional and national electronic switching centres to aggregate and redistribute all transactions. Because of the one-at-a-time, immediate-response nature of these transactions, these centres will be much more complex technologically, and much more expensive than the A.C.H.'s described earlier for pre-arranged payments.

The elements of complexity and cost give rise to a very real possibility that on-line E.F.T.S. systems could give large financial institutions a major competitive advantage over the rest of the industry. A further point to consider is that transaction volumes will increase substantially while float will diminish correspondingly.

In this paper, we shall not concern ourselves with the overall economic effects resulting from the implementation of EFTS. On the other hand, we are concerned with the proper structure of the processing mechanisms and the position of each financial intermediary and the government within the system.

C. The Possible Choices:

There are four basic methods by which the systems could be implemented; firstly by allowing the chartered banks to set up and operate their own systems; secondly by having an independent government system; thirdly by an approach whereby the government uses banks' regional facilities as clearing houses and lastly by instituting a common user utility, private, public or combined.

D. Implications:

The first possible choice has been ruled out by virtue of the previously stated objectives of the

government. Indeed, as summarized in a statement made by Donald Baker of the U.S. Antitrust Division of the U.S. Justice Department, A.C.H.'s "cannot be used to restrict competition between commercial banks and thrift institutions... while they may try to assure outsiders that they will serve all on the same basis as any other customer, thrift institution officials worry that A.C.H.'s may be administered by commercial banks to the detriment of non-bank financial institutions." The potential is certainly there and the above statement captures a worry which is shared in Canada by non-bank financial institutions, should banks have control of E.F.T.S. Chartered banks in Canada have accumulated the greatest amount of knowledge and experience in this field but it is assumed that it would be wiser to make their knowledge and experience available to others rather than to let them control the system.

The second system is an acceptable one conceptually and in the U.S. many institutions have indicated their willingness to have the Federal Reserve System ("Fed") run the entire system of clearing houses and most are at least in favour of seeing the "Fed" operate the interbank transfer system. A few individuals, however, have expressed the fear that the wholesale intervention of the Federal government is equivalent to a "nationalization of the payments mechanism." Currently, in the U.S. it is expected that the "Fed", which is operating the Atlanta and San Francisco clearing houses, is likely to open and operate 37 additional A.C.H.'s or one for each of its cheque clearing centres. In Canada, the situation differs, in that financial institutions have expressed some reluctance to accept a totally government owned and operated system, and in addition the government does not appear anxious to undertake the whole task single-handed. The Canadian response has been a slightly delayed reaction to U.S. events and an attempt to tailor these to a Canadian perspective. The Canadian government, admittedly lacking sufficient experience in this field and fearful of duplication of existing resources, is not seriously considering this alternative.

The third possibility is to institute a joint operation between the public and the private sector. This is the possibility to which the Federal government has been giving the greatest amount of thought. As it stands, from its Department of Supply and Services (D.S.S.), it would send down all its taped information to a designated receiving bank (a different chartered bank in each region of the country) acting as an A.C.H. The regional A.C.H. will forward credits to the processing branch which will in turn send the listed credits to the non-bank financial intermediaries' branches or offices. Six regional exchange points are proposed, each one to be manned by one of the chartered banks.

This proposal which covers only direct Government payments relegates the trust and loan companies to the last rung on the ladder and interposes the chartered banks into all transactions. There appears to be a superfluous step in the system and no valid reason to have N.B.F.I.'s twice removed from the A.C.H. The presence of N.B.F.I.'s in the system should be accepted on the same basis as any bank and they should therefore have direct access to the A.C.H. Furthermore, it is reasonable to assume that transmission from the A.C.H. to an N.B.F.I. directly is simpler than indirectly through a bank branch and consequently less likely to fall prey to errors and recording problems.

This approach, although perhaps adequate for handling batched Government payments and the like, falls far short of the technology and service to all deposit taking institutions which will be necessary for future card/terminal activated, on-line E.F.T.S.

The main concern of trust and loan companies in the implementation of E.F.T.S. is that the systems may be designed in a manner which will impede their growth or remove them from certain financial markets altogether. Trust and loan companies rely heavily on the service aspect of their financial operations and, as on-line electronic facilities cater to customer convenience, trust and loan companies have to place themselves in the forefront of change in order to maintain their market strength.

The advent of E.F.T.S., among other things, means that the customers or depositors of a trust or loan company will be able to assure the handling of mortgage payments and rents, by automatic withdrawals, participate in automatic savings plans, and deposit payroll cheques, dividends and other payments directly into their accounts. In all these cases, there is ample reason to make certain that trust and loan companies become an integral part of the system from the very beginning and there is no apparent need for interposing bank branches between the A.C.H. and N.B.F.I.

Trust and loan companies that have evolved towards a greater and greater involvement in the provision of personal financial services the savings function and mortgage lending will see their future depend heavily on their ability to market these services promptly and efficiently, which will make electronic aids a prerequisite. It is absolutely evident that if the consumer convenience provided by an E.F.T.S. is reserved for the banks, or if the latter have an advantage in the operation of an E.F.T.S. mechanism, the trust and loan companies will see their viability as financial institutions erode drastically, much to the detriment of the financial system as a whole.

Lastly, it must be pointed out that a card-activated on-line E.F.T.S. is a relatively inexpensive way of expanding the activities of deposit taking institutions without having to go through the branch route. Remote terminals can be placed in numerous areas and business can be transacted readily from points where an N.B.F.I. had no offices previously. Guaranteeing equal acess to the E.F.T.S. to trust and loan companies consequently also ensures their ability to grow at will into many points which they would have thought previously inaccessible because of the cost associated with opening a branch. Needless to say, providing the trust and loan companies with an opportunity to expand their market reach without incurring heavy costs is likely to guarantee both an increase in the flow of savings to the industry and greater competition within the financial system by virtue of the trust companies' more rapid growth through expansion. It should be added that although banks would probably also increase their market reach through terminals, relative to trust and loan companies, this market extension would not constitute as large an increment over their present widespread branch system.

E. Conclusions and Recommendations

We therefore conclude that a common user utility readily accessible to all would-be participants, directed solely by the needs of its own service function, and providing a service on a cost/use basis would be the most neutral and most adaptable solution given the present structure of the Canadian financial system and the needs of the economy.

We therefore recommend that the Government consider the formation of a common user utility to implement and operate the accessing and processing mechanism associated with the advent of electronic funds transfer systems and attendant developments.

3. LONG TERM DEBT INSTRUMENTS AND THE CANADIAN FINANCIAL INSTITUTIONS

A. The Issue:

Financial debt instruments other than corporate debentures are currently issued by most financial institutions in the form of term deposits, guaranteed investment certificates and guaranteed notes. The question which arises is whether the financial system functions best with an open market or whether certain institutions should be restricted to issuing debt instruments of a certain maturity range.

B. Background:

Much of the financial system which we have inherited today has been the result of a gradual evolution. The system's development has not been dictated by legislation but has evolved in a free form with much of the legislation being implemented in a remedial fashion or as the need arose. The Canadian financial system as a whole has enjoyed a reputation of stability and conversatism despite, or because of, its relative freedom from government interference.

The resulting market is shared by a variety of intermediaries who often overlap one another in financial markets, both in the demand and supply of funds. For example, while the chartered banks have dominated the chequing, non-interest paying demand deposit field, which has been an important source of funds for them, the other element in the demand deposits area, non-chequing savings deposits have been competed for by a great many financial institutions. The competition for non-chequing demand deposits is consequently much stiffer than that for transactions balances which are mainly in the hands of the chartered banks.

Personal savings are usually maintained in the form of an interest-bearing savings account, or a term deposit. Term deposits from thirty days to five years are offered by chartered banks, credit unions and co-operatives, while trust companies offer guaranteed investment certificates (G.I.C.) from one year to five years, and term deposits from thirty days to 364 days. We would define the long-term savings instrument as any term deposit or G.I.C. with a maturity of from 100 days to five yearseurposes of this submission.

The G.I.C. technically carries a higher degree of security than a term deposit of a chartered bank by virtue of the statutory guarantee attached to it. From the point of view of the saver, however, interest rate differentials appear to have more influence on the choice of an instrument of deposit than the nature of the institution providing it. Term deposits and G.I.C.'s appear to be virtually interchangeable as savings vehicles and consequently a small increment in one institution's rate of interest paid on deposits will attract a flow of funds.

Financial institutions using the personal savings market as a source of funds have a great variety of uses for these funds. For example, banks bolster their liability base with term deposits of varying maturities, and, in turn, lend mostly on a short term basis with up to 10% of their assets consisting of mortgages which have a longer maturity. Trust and loan companies who depend largely on G.I.C.'s as a source of funds use them principally to write mortgages of maturities matching or exceeding the terms of the deposits.

The competitors for long term savings deposits in the financial market fall into two distinct categories: the non-bank financial intermediary institutions and the banks. As we have described in the section on the nature of banking, however, the difference is significant since trust and loan companies, for example, need not maintain the monetary aspect of their financial assets while banks operate as providers of universally accepted means of exchange, and are therefore closely tied to monetary criteria and consequently central bank control.

B. The Possible Choices:

There are three logical choices: one which permits all financial intermediaries, bank or non-bank, to compete for savings deposits in an unrestricted generalized manner. The second choice is to restrict the access to long term savings as a source of funds to the non-bank financial intermediaries. The last choice is to reserve it for the chartered banks.

C. Implications:

a) The first choice would represent an extension of the existing situation. Competition would be enhanced by the presence of virtually all Canadian financial institutions. Interest rates paid would therefore be maintained at a high level which is generally accepted to be advantageous to the depositor. This, however, may not be an absolute benefit since lending institutions have to maintain a certain operating margin and would consequently charge a higher rate to the borrower. In this case, the saver's gain is the borrower's loss. One may surmise that the presence of powerful intermediaries such as chartered banks would bias the market and increase the cost of funds' sources to other institutions. The chartered banks' average cost of funds has been traditionally lower than that of other financial institutions; it is therefore feasible for them to borrow at a high marginal rate and still earn a larger spread than other institutions. The principal reason is that the degree of interchangeability which exists between the term instruments issued by various bank and non-bank intermediaries is such that a rise in the interest rate paid by banks will have to be closely matched by other institutions on similar instruments.

   Chartered banks may therefore be in a position to exert such pressure on the term instrument market that they would render this form of funds source unprofitable to other intermediaries. There is evidence for this in the actions of the short term deposit market from time to time. It will be remembered that unbridled competition for short term deposits caused the intervention of the Minister of Finance in 1972 resulting in the so-called Winnipeg Agreement. To a lesser extent, banks may cause the price of savings to rise for other intermediaries solely by virtue of their active presence in the market. As mentioned earlier, this may be of marginal benefit to the saver who receives a higher interest rate but certainly to the detriment of the borrower.

   In an efficient market, uses of funds must correspond to sources of funds as closely as possible with respect to terms and conditions for all institutions, otherwise, one institution may gain a substantial advantage over the others, or alternatively the integrity of the system may be threatened by instability. Chartered banks in Canada capture transactions balances as well as savings accounts; trust and loan companies on the other hand are more restricted and have to find funds in a narrower market to service a substantial demand from long term borrowers. Relating the uses and sources of funds for chartered banks and trust and loan companies respectively, we notice that, while banks are mostly short term lenders, they are both short term and long term borrowers. On the other hand, trust and loan companies have limited access to demand deposits since these mainly arise from commercial lending business. In view of the fact that chartered banks do not necessarily have to match maturities, they have a greater advantage and flexibility. The inherent advantage of this flexibility of the chartered banks makes it more difficult for trust and loan companies to assemble the funds required to fulfill the large demand for long term funds and more specifically for mortgages. A better balance for the financial system as a whole should prevent long term borrowers from using funds in the short term lending market.

   Presently nothing precludes banks for example, from applying all their long-term sources to short term uses. This may be damaging to the long term borrower who may not be able to fulfill his demand at reasonable cost because of shortage of supply and to the non-bank financial

intermediaries who have no alternative source to tap in order to fill the demand for long term funds. To the extent that there is a real social need for long term funds, banks should therefore be precluded from tapping long term savings to avoid distortions in the financial markets.

From the arguments outlined in the section entitled ''Intermediation and the Nature of Banking'', it would appear logical to exclude chartered banks from term lending. Indeed we demonstrated earlier the inappropriateness of their participation in the mortgage market. We have considered whether or not there should be legislative restrictions on the term of their assets and we feel that this may be necessary only on their liabilities. It is felt that if banks were restricted in the length of maturities of their liabilities they would make voluntary adjustments to the composition of their asset portfolio to reflect their attitutde towards risk and profitability and to meet their needs for liquidity. Accordingly we believe that this is best achieved through the workings of the market place and that legislative restrictions may not be required in this case.

There is some serious concern that the extent of activities of the banks in the term borrowing area has displaced other financial intermediaries and has consequently impeded the latter's growth and competitive ability. In addition to this we should be aware of two problems which find their origins in the banks' involvement in term lending and these problems should be considered carefully in the context of the effectiveness of monetary policy and liquidity.

If banks are heavily involved in term lending, as normally occurs in an expansionary phase, when monetary policy becomes more restrictive it becomes difficult for banks to disengage themselves from their long position and provide the necessary liquidity. The ensuing time lag as well as the added pressures on the system which would not normally occur if banks were in a shorter and more reversible position make monetary policy less immediate and less effective.

Another danger arises when banks have been allocating substantial assets to term lending: as mentioned above the banking system though not necessarily less liquid, becomes less reversible and the potential for adding liquidity to the system is diminished considerably. Thus, when money tightens and business demands switch from term borrowing to receivable and inventory borrowing, the banks are no longer capable of reversing their position fast enough to accede to all the requests. The Bank of Canada may then be placed in the untenable position of having to increase the moneysupply at an undesirable rate in order to meet the ordinary demands of the business sector. This may result in a more rapid increase in the money supply than would otherwise take place. Furthermore, as indicated, this is most likely in a period where the Bank of Canada would prefer to see some contraction taking place. However, because of the banks' involvement in term lending the central bank may be subsequently forced into a stance which would defeat their initial intent.

Turning back to a consideration of deposit limitations, it may be said that the chartered banks are effectively offering deposits of 100 days or less now, in that their term deposits are callable, (with an adjustment of interest), are therefore within our suggested limitations, and that we are in effect endorsing the status quo.

The vital point is that these deposits are presently callable at the holder's option. The reason for propounding the limitation is to facilitate transmutability by the bank, with the attendant improvement in the stability of the system. The change would indeed be substantial.

If chartered banks are to operate as true banking institutions devoted to the retention of the monetary characteristics of their liabilities, they should be precluded from issuing term instruments. Term instruments lose their monetary characteristics since they are no longer bank liabilities which provide the depositor with a readily acceptable means of exchange. Holding the chartered banks to a true monetary and banking function would logically exclude them from seeking long term deposits.

b) The second choice implies reserving long term savings deposits for institutions using these funds to supply long term loans, particularly mortgages. Chartered banks, being excluded, could still raise long term capital for their own needs by issuing debentures.

The disadvantages of having the chartered banks compete for term deposits have been outlined above; the advantages of giving only non-bank financial intermediaries access to this market is the obverse of the disadvantages. Provided that these funds could be channelled into the mortgage market and other socially acceptable long term borrowings, the financial system would be much more likely to reach an equilibrium resulting in a better and less expensive service to the customer. Furthermore, the current high demand for mortgages and other long term funds would undoubtedly be met more easily.

c) The last possibility would be to allow the banks exclusive access to time deposits. In addition to the reasons given above, the resultant upheaval in the financial system precludes serious consideration of this option.

E. Conclusions and Recommendations

We conclude, therefore, that chartered banks should be excluded from taking long term deposits for the following reasons:

a) Their presence could imply an increase in the cost of funds to other intermediaries and to the ultimate borrowers;

b) banks could channel long term sources into short term loans, consequently creating instability in the financial system;

c) tapping the long term deposit market removes the chartered banks from a true monetary and banking function.

Consequently, we recommend the following in regard to the Bank Act:

1) Canadian chartered banks should be precluded from accepting term deposits in excess of 100 days maturity (which corresponds to the recommendations of the Porter Commission).

2) That non-bank financial intermediaries who respond to the demands of long term borrowers should have exclusive access to the market for time deposit certificates in excess of 100 days.

Recognizing that the implementation of these recommendations would create temporary disruptions in the financial markets we recommend that changes be made over a period of time which corresponds to an anticipated adjustment lag.

V ISSUES OF SPECIFIC CONCERN

The Canadian financial system is continually undergoing a process of adjustment to reflect and anticipate changes in economic requirements, social values and the dynamics of private/public sector interface.

We intend to examine in this section a number of specific issues, each of which is important to the trust and loan industry, but which also have a collective significance to the direction of future developments in the financial system as a whole.

In the light of our previous discussion about the nature of banking we shall look at the "fit" of function and the suitability of the accepted financial instrument to a particular type of intermediary institution and the most desirable inter-relationship between institutions.

Each issue offers to one or more types of intermediary institution a present or future opportunity, or represents a constraint, and will be examined separately against the background of our previous findings with respect to the nature of banking and the requirements of efficient intermediation.

1. BANKS AND TRUST POWERS

A. The Issue:

The question is whether or not chartered banks in Canada should be authorised by an amendment to the Bank Act, to seek trust powers.

B. Background:

By a combination of legislative design and perhaps historical accident Canada has retained a financial system in which the fields of insurance, commercial banking and fiduciary services are carried out by different classes of regulated institutions. While there has been some overlap and there appears to be some current pressures by certain institutions to increase this overlap, the primary distinctions remain in force.

In Canada it is estimated that 60 percent of the trust business is handled by individuals (often lawyers or notaries). The other 40 percent is handled by corporations duly incorporated and regulated whose major function is one of acting in cases requiring the presence or intervention of a trustee. Banking and trust functions have remained distinctly separate with trust companies not carrying out banking, a monetary function, and chartered banks not being vested with trust powers.

On the other hand, in the United States, trust powers are conferred upon banks and the separation of banking and fiduciary services has never been made. It should be pointed out that this combination of powers under one corporation has not been without its attendant problems for the U.S. Public and private concern about potential conflict of interest situations has reached a point that is causing some legislators to call for the complete separation of the two activities. In practice, certain institutions have already undertaken procedures to avoid any exchange information between their commercial and fiduciary areas. The entire "Chinese Wall" concept is an artificial separation within the same bank to prevent fiduciary personnel from gaining access to credit information and commercial banking personnel from taking part in the investment decisions of the fiduciary side. This has not been entirely successful as recent court cases in the United States have demonstrated.

Today, in Canada, we benefit from the extensive experience of the United States' banking system and its combination of trust and banking powers, and we suggest that the experience of the U.S. provides us with a fair measure of what problems arise from allowing banks into the trust business.

C. The Possible Choices:

The only possibility which we wish to examine here is the viability of granting trust powers to the Canadian chartered banks.

D. Implications:

The only advantage that one can envisage in a situation where banks have trust powers is that they would be able to handle directly certain trust functions which they are currently obliged to surrender to trustees. In certain isolated circumstances this may represent a cost saving to the banks but in general, since they lack the necessary staff and skilled expertise it would be a limited benefit and would probably not be conferred on the ultimate consumer. The chartered banks' extensive branch system could not provide the Canadian public with any advantage since, for reasons of efficient deployment of resources, few branches would be staffed with the necessary fiduciary experience and skill and consequently could only perform a referral function to higher levels.

The disadvantages of having banks undertake fiduciary functions are numerous. In the first instance, as pointed out explicitly in the section on Intermediation and the Nature of Banking, the potential for an economic conflict of interest in the intermediation function would be substantial. This point need not be reiterated in the development of this specific issue, despite the fact that there has been a proliferation of legal cases of conflict of interest in the U.S. because of the dual function allowed within their banking system. There is no reason to suspect that the Canadian banking system would escape the problems demonstrated in the U.S. if they were vested with trust powers. In fact, the size of the individual banks in Canada by virtue of the extent of their activities would lend itself to a greater potential for a conflict of interest.

In the second instance, trust powers are easily recognizable as a non-banking function. It is a remotely bank-related activity since some bank business requires fiduciary presence. One must distinguish strongly between banking functions and bank related activities. Under our own terms and most people's, trust powers and fiduciary activities are not considered a banking function; furthermore, it is only a remotely related activity, not being a necessary part of a bank's operations. The presence of banks in the fiduciary business would not only be contrary to a true banking mandate but would dilute the effectiveness of the chartered banks as a financial intermediary. Instead of recapitulating our previous arguments on the definition of the banking function, we will limit ourselves to restating that the banking function relates to the function of money within our economy and should pertain to this only. Fiduciary powers which basically relate to the management and administration of property add nothing to a bank's monetary function and seriously degrade its position as an intermediary by raising a host of potential conflict of interest problems. For this reason we wish to recommend against granting chartered banks fiduciary powers of any sort.

In the third instance, in response to the argument that, if they were in the trust business, banks would provide an improved public service and increased competition, we suggest that there is no concrete indication that they would, that competition exists presently among firms within the industry and that this competition is of sufficient scale to guarantee low costs to the public and to make one realize that the introduction of another industry which does not possess the necessary skills will neither increase availability of services nor provide an additional benefit to our society.

The banks may use the argument that their branch coverage would bring the service to more Canadians. Two arguments against this have already been pointed out. First the specialized nature of the business would mean that most branches would only be referral offices. Secondly, the increased competition would continue to erode the financial base of the trust companies and reduce the latter's incentive to expand their branch coverage in competition with the banks.

It may be said,from the evidence in the statistical section, that trust companies have largely subsidized their E.T. & A. business through their more profitable financial intermediation business. The increased complexity and cost of E.T. & A. business suggests that the duplication of such a highly specialized function as trusteeship does not justify a duplication within our economic system and social needs. Fiduciary services are currently provided to the Canadian public at extremely low costs which are generally dictated by the courts. In view of this, E.T. & A. business in itself is not an activity which provides the trust companies with a high margin and consequently it is doubtful that increased competition could reduce costs to the public. On the other hand, if banks were to provide fiduciary services, it would mean mobilizing a large number of people and a high level of talent which would be a net cost to our society and financial system. It is our belief that the gains which might be achieved through a marginal increase in competition would not offset the costs associated with mobilizing the manpower resources necessary to enable chartered banks to perform a proper fiduciary function.

In addition to the economic and legal arguments propounded above, we suggest that the possibility of the banks subsidizing their entry to a market with a view to eliminating competition

could be as much a factor in their acquisition of trust powers as in leasing or term savings.

We do not, in fact, suggest that the banks are anxious, or even willing to duplicate the extensive range of fiduciary services offered by the trust companies. The regulated nature of much of the compensation, the low rate of return on equity, and the time span required to make trust operations self-supporting are potent disincentives to a wholesale entry into the fiduciary field.

More attractive to the banks would be the ability to act as trustee in certain limited capacities, which would strengthen their lending and investment actvities, in addition to offering a new area of profitable expansion. We shall be dealing specifically with the banks' activities in RRSP and RHOSP tax shelters later in this submission, so we confine ourselves here to pointing at these as prime examples of activities which attracted the banks as an opportunity to expand their deposit base.

Corporate trust activities would support bank corporate lending, specifically stock transfer and bond trusteeship. They would, however, intensify the ''tying'' and potential conflict of interest problems, which we regard as being already severe.

The ideal situation from the point of view of any new entrant to the fiduciary field would be selective entry into all fields. Because court awarded compensation has traditionally been based on percentages of capital value or revenue collections, negotiated fees have followed a similar pattern. This has led to a degree of subsidisation by large accounts to smaller ones, in addition to the subsidy from intermediary operations to the trust function.

Selective entry into all fields would give the banks the opportunity to use their connections to enter the market at the profitable end. This would produce modest profits for the banks, and a far more significant offsetting decrease in revenue and profits for trust company fiduciary operations.

E. Conclusions & Recommendations

We conclude therefore that fiduciary powers should not be conferred upon Canadian chartered banks because:

a) the exercise of such powers is not a true banking function;
b) such a course would present a serious potential for conflicts of interest both legal and economic;
c) competition within the industry is sufficient and would not be enhanced;
d) introduction of banks into a trust function would entail the mobilizing of manpower resources representing a great cost to society with no corresponding benefit.

We therefore recommend the following in regard to the Bank Act:

1) That Canadian chartered banks should not be authorised to seek fiduciary powers.

2. REGISTERED RETIREMENT SAVINGS PLAN AND REGISTERED HOME OWNERSHIP SAVINGS PLANS

A. The Issue:

Government sponsored tax shelter plans have been a feature of the tax scene and Canadian financial planning for individuals since the late 1950's. Despite the time elapsed, there is still some controversy as to the nature of the instrument, and the type of institution suited to handle them.

B. Background:

The first tax shelter, the Registered Retirement Savings Plan, (R.R.S.P.) was introduced b the federal government as a means to encourage, by a limited tax exemption, a higher percentag of savings for retirement from those taxpayers who were not covered by registered pension plans The legislation also permitted those who were so covered to open R.R.S.P.'s and supplemen their retirement income. The prescribed format for the plan was that of a trust, with a specia amendment to the Insurance Act opening the field to the life insurance companies. Publi acceptance of the tax shelters was relatively slow until the mid-sixties when a combination o growing public acceptance of tax advantages, buoyant stock markets and recognition of th advantages of the plans by professional groups such as lawyers and chartered accountants bega to increase the growth rate substantially. At this time the chartered banks may have bee interested in participation, but their lack of trustee powers appeared to be an insuperable problem

Throughout the late sixties R.R.S.P.'s continued to grow — new registrations reached recor levels year after year, but there was a significant change in the composition of the contributions The public rejection of the stock market expressed itself in an increased percentage of mone being placed in the Guaranteed Funds of trust companies' managed R.R.S.P.'s which ar basically of two types:

1. Deposit account equivalents, with rights of withdrawal or transfer at any time, and with interest rates reviewed periodically on all funds deposited.
2. Guaranteed Investment Certificates (G.I.C.), eqivalents with a fixed maturity, automatic reinvestment of income, and interest rates for the term to maturity on each separate deposit.

At this point, chartered banks saw the opportunity to acquire a new, stable and long-term source of funds, from which they were excluded on a direct basis, but which could be reached providing they were able to find trustees to intervene between bank and client. While the arrangements varied from bank to bank, all were predicated on sales through the bank branch system, with the emphasis on a new type of bank deposit.

So far the banks' objectives could readily have been accommodated within a recognized trust framework. The banks, however, insisted as a prerequisite on performing all trusteeship functions including investment management, accounting, recordkeeping, and retention of custody of all assets as if they were trustees, overcoming their lack of legal power by creating a façade of quasi-trusteeship. The trustee, unable to delegate his fiduciary responsibilities, and precluded from exercising them, was to be indemnified by the bank against all claims and any consequent loss.

The chartered banks did not find it easy to persuade trust companies to act in this quasi-trustee capacity. Several major trust companies rejected one or more banks on the basis that unless the arrangement were changed to give the trustee custody of the assets, control of receipt of contributions and accounting functions, they would not lend their names to the plans.

The banks, however, succeeded in persuading one trust company to act in the capacity of quasi-trustee, and the remaining companies were then faced with increased pressure, and a precedent, with the result that more such agreements were formulated between banks and trust trust companies.

In its May 1974 Budget the federal government announced its intent to alleviate home ownership problems and assist would-be owners by authorizing a new form of tax shelter known as a Registered Home Ownership Savings Plan (R.H.O.S.P.). This was again to consist of a trust, limited to a total of $10,000, with maximum contributions at the rate of $1,000 per annum.

Because of the dissolution of Parliament and subsequent general election, the enabling legislation was not passed until March 1975, but was in essentially the form announced in 1974. This is significant in that the government had ample opportunity to amend the form of the R.H.O.S.P., but chose to retain the trust concept, notwithstanding very strong representations from the chartered banks.

In addition to their attempts to change the format of the R.H.O.S.P. to permit direct access to the market, the banks had, in the intervening period, approached their several R.R.S.P. trustees and proposed quasi-trusteeship arrangements identical to those negotiated for R.R.S.P.'s. They were in each and every case rejected.

The trust industry, having recognized its original error in undertaking quasi-trusteeships for R.R.S.P.'s, was nevertheless mindful of the government's objectives of wide distribution to permit the benefits of the new tax shelter to be extended to the maximum number of eligible Canadians. The industry recognised that this could be accomplished by making use of the chartered banks' branch network while it rejected the expediency argument which says that because the banks have the physical capacity, they should be given powers to match.

The trust companies therefore approached the banks with a proposal that the banks should act as their agents in the distribution and sales of R.H.O.S.P's, but with the administration remaining in the hands of properly regulated corporate trustees. The chartered banks flatly refused to accept an agency arrangement for any duty constituted trust company in Canada. They made no serious effort to ascertain the possible terms of such arrangements. Instead, they insisted that trust companies act as quasi-trustees to enable the banks to do indirectly what they were not permitted by law to do directly.

The necessity for any decision as to the validity of the arguments of the respective parties was avoided when all the major banks acquired the same trustee on their own terms, a recently incorporated company whose fiduciary experience was negligible.

Either the R.R.S.P.'s and R.H.O.S.P.'s were properly created as trust instruments with the intent that they be handled by a qualified and competent trustee, or they should be defined as something else.

The present situation represents an acquiescence by government in arrangements that defeat the plainly stated intent of the terms of the legislation.

We would add that the nature of the funds deposited in R.H.O.S.P.'s is clearly long-term, and by definition should be made available to the institutions investing in longer term assets such as mortgages.

C. Conclusions and Recommendations

We conclude that if the individual tax shelter plans initiated by the government are to be designated as trusts, the banks should be precluded from exercising their formidable power to create arrangements permitting them to do indirectly that they are prohibited from doing directly. We suggest what the proper function of a chartered bank is in the distribution of the plan as agent. We also conclude that, to meet social objectives, the pool of long-term savings represented by R.R.S.P. and R.H.O.S.P. should be channeled to institutions investing in long-term assets.

We therefore recommend with regard to the Bank Act that:

1. Banks should be precluded from performing fiduciary services, (including administration or accounting) either directly or indirectly, for individual tax shelter plans.
2. The recommendation in 1. above should not be expressed so as to preclude the banks from acting as sales agents for individual tax shelter plans offered by qualified and regulated corporate trustees.

3. LEASING

A. The Issue:

The issue may best be defined as a quest for the most appropriate ''operators'' of leasing powers within the Canadian economy, based on the criteria of benefit to the economy and improvement in the efficiency of financial markets.

B. Background:

Leasing is not new in Canada but it has only recently become a popular means of equipment financing and the market is now large and highly competitive. Except for the leasing of rolling-stock, in 1960 leasing was a newly introduced means of financing and the total volume in Canada was only $50 million. By 1973 the volume had risen to about $1 billion, of which approximately one half was made up of financial leases and one half of operating leases. Financial leases have proven relatively more attractive in terms of current legislation and estimates are that by 1978 they will amount to $2 billion and operating leases to $650 million. In 1973 the current growth rate was approximately 35% per annum for financial leases and 5% per annum for operating leases.

The difference between financial and operating leases lies principally in the recovery of the asset cost. In a typical financial lease, the lessor amortizes the entire cost of the asset plus his profit over the term of the lease. The lessor of an operating lease recovers only a portion of the asset value, the balance being usually recovered either from the sale of the asset upon the lease's termination or through re-leasing the equipment.

The leasing market may be considered in three segments, with each segment comprising a separate market. The small ticket lease comprises items ranging in value from $1,000 to $250,000 and the lease is usually arranged through the retail services of a leasing company. The terms range up to five years with interest cost to the customers between 14% and 18%, depending upon rate structure and the specific nature of the lease.

In the medium size market, where items cost between $250,000 and $2,000,000, competition is more intense, rates closer to prime and institutions other than leasing companies enter the market. Negotiations take place directly betwen the parties and terms and conditions tend to vary from deal to deal, depending on the nature of the equipment leased at these prices.

For items over $2 million, lessors usually bid in direct negotiation with lessees and since the lessees are usually large corporations of established financial status, the leases are relatively riskless and rates consequently lower than in other cases.

Leasing has become popular primarily because of certain tax advantages which may exist for both lessor and the lessee. The lessor of the equipment benefits from the capital cost allowance to the owner while the lessee benefits by deducting the cost of the lease from his taxable income. Thus the lessor is able to shelter some of his income, often through the accelerated depreciation schedules allowable on industrial machinery, while the lessee deducts his leasing costs from his revenue as a business expense and conserves working capital or credit lines.

In 1972, 14 companies offered leasing services in Canada: by 1973 the number had grown to 41 and currently there are over 50 companies actively engaged in the leasing business. Until a few years ago, Canadian leasing and financial companies were handling most of the small and medium size leases, with the large ones generally being done in the U.S. or in joint ventures. Most of the new entrants in the field are foreign in origin, drawn to the relatively undeveloped Canadian market by their own superior expertise and favourable tax treatment. There are now about 35 companies operating in Canda which are foreign controlled, many of them by U.S. banks, with others from Britain, France, Switzerland, Germany, Italy, Japan, etc.

Canadian chartered banks reacted to the moves of foreign financial institutions into the leasing business by taking substantial equity interests in leasing companies. In 1974 five chartered banks owned substantial equity in leasing companies whose assets amounted to more than $600 million.[1]

The Bank Act prohibits Canadian banks from the direct entry into the leasing field that they desire, by restricting them to assets used for banking operations, such as their own premises, etc. The Canadian chartered banks have easily bypassed this restriction by entering the market indirectly through affiliates and subsidiaries.

Recently, however, the banks have become more vocal, asking that the Bank Act be revised in order to allow them to extend full fledged leasing services through their branch system. There are many reasons why the banks are interested in this area; firstly, they have witnessed the profitable performance of foreign banks who have been gaining an impressive share of the leasing business in Canada; secondly, because they feel that leasing services extended through their branch banking system would be an effective dissemination of this form of financing and thirdly, because they feel that a vacuum exists in the leasing business which they are best suited to fill. In a speech delivered on June 6th, 1975, R. Donald Fullerton, Executive Vice-President and Chief General Manager of the Canadian Imperial Bank of Commerce, made the bank's position explicit. He pointed out that an estimated 75% of Canadian leasing business is being written by subsidiaries of U.S. and other foreign financial companies. He added that if banks were allowed to enter leasing directly, "lease financing would be available through all branches of the banks, making this means of access to capital goods available to the many firms now locally served by the extensive branch bank network". He also argued that it could mean lower rates for the leasing customers as a result of competition.

Trust and loan companies have not been active in the field of equipment leasing and have generally participated through affiliation or through joint ventures, as for example when The Royal Trust and Canada Permanent Trust participated in the leasing of two Lockheed 1011 aircraft to Air Canada. Most trust companies have played a more passive role, watching the developments in the market and participating on an ad hoc basis whenever a suitable and profitable occasion arose.

The main Canadian lessors have traditionally been leasing and finance companies. These companies have well developed markets in the small and medium size lease business but have been worried about the foreign banks' entry because the latter's net money cost is generally lower than their own. Indeed, foreign institutions have been able to raise money on the Canadian capital markets at relatively lower costs by attaching the guarantee of their foreign parent to the note. The leasing companies are even more worried about the chartered banks entering the leasing market since the banks could virtually eliminate the leasing companies through the fact that the banks' normal cost of money is lower than the leasing companies and thus the banks have the power to subsidize their entry into a market to guarantee their own long run profitability in this field. Given the present market and the financial power of the banks,no financial institution could compete with the banks profitably if banks were given the means to enter this market without restriction.

Other financial institutions have either not expressed a direct interest in leasing, are testing the water through small ventures or are awaiting the developments in the Bank Act in 1977. Given the current and growing importance of leasing, government decisions in this area are likely to alter the structure of the Canadian financial system and markets.

(1) See Financial Intermediation and the Nature of Banking, Chapter 6(B).

C. The Possible Choices:

If the government gives consideration in the Bank Act revisions to the institutions that should have leasing powers, it will have three basic choices. The first one is to allow the present system to continue on the same basis, the second is to allow the banks to enter the field of leasing directly and the third one is to permit some modification to the existing mechanism without giving chartered banks direct leasing powers.

D. The Implications:

a) Maintaining the status quo will itself generate some structural changes in the long run. Though any anticipation of change from the present status is a matter of speculative forecasting, certain hypotheses lend themselves to a realistic view of a developing and dynamic market such as the market for equipment leasing in Canada.

In the first instance one can surmise that the popularity of financial leases as compared to operating leases will continue and will attract more financial institutions into the market resulting in sustained competition. The domestic leasing companies are concerned about the foreign competition. This comes from two sources. First, the Canadian subsidiaries of foreign financial institutions, primarily banks. These raise money through the Canadian money market, mostly with the parent's guarantee, they have a high leverage, sometimes as high as 200 to 1 and they are not required to maintain reserves or liquidity. Thus their average cost of money including the cost of capital is less than the domestic leasing companies. These companies are entirely unregulated and it seems appropriate that proper leverage and reserve requirements be imposed on them. Secondly, the so-called ''suitcase banks'' use the funds and capital cost allowance of the parent institution to compete in the Canadian market. It is unlikely that in practice these can be regulated and it is doubtful that the acutal volume placed in Canada should be a source of concern.

Thus, if the leasing market retains its present dynamic and profitable profile, the overall gainers will probably be the foreign affiliates, the ''suitcase banks'' and the domestic bank subsidiaries. To the extent that there exists a vacuum between these three, other domestic financial institutions will progressively enter the market.

In summary, provided that foreign banks in Canada are controlled so that their operations are not carried out to the detriment of Canada's capital flow position and are not a threat to the stability of the financial system, their presence would appear to be a positive competitive factor, tending to maintain low rates and good service to the lessee. The major problem anticipated in maintaining the status quo is that the competitive advantage which the foreign banks might have may place them at an unfair advantage vis-à-vis the domestic leasing companies. This is especially likely to affect non-bank affiliated domestic leasing companies who have traditionally experienced higher borrowing costs. In the second place, the uncontrolled growth of affiliates of foreign banks in Canada may disrupt the capital markets and the credit control power of monetary policy. This may ultimately cause some negative longrun economic effects which would outweigh the benefits obtained from the lower rates which the foreign bank affiliates are capable of providing to the Canadian lessee.

b) The second possibility is to allow the chartered banks to enter the leasing business directly. They themselves have suggested that if the Bank Act were amended to allow them to enter the leasing market they could extend a more widespread service than at present, by virtue of their branch system. Mr. Fullerton of the Canadian Imperial Bank of Commerce, contended that their direct presence in the market would ''lead to lower rates for leasing customers because of the increased competition''. Another argument which the banks have used is that leasing is a financial service which is very similar to a term loan and therefore banks should be allowed to enter this market directly.

Under the terms of the Bank Act, banks are restricted to holding assets that are used only for their own banking purposes and operations. By leasing directly banks would also benefit from the capital cost allowance on equipment which they could use to shelter their taxable income. This way, banks could temporarily defer a high proportion and possibly all of their corporate tax payments. This would reduce the government's cash inflow substantially and the potential loss in tax revenue makes the proposition politically unappealing.

There are four reasons why chartered banks in Canada should not be allowed to enter the field of leasing directly. These reasons also apply to their being involved in the business indirectly, so that the possibility of having banks divest themselves of their holdings in their affiliates is also a necessary condition for banks to remain within a true banking function.[(1)]

The first argument against chartered banks' involvement in the leasing business already exists in the Bank Act. The ownership of goods, which leasing implies, is not a banking function. There is a real difference between acting as a financial intermediary, especially a banker and being a lessor. Though a lease may be guaranteed by the lessee, in the final analysis it is not a liquid instrument and is limited to the residual market value of the equipment. If banks were allowed into leasing, their involvement would constitute in part a speculation on the value of a piece of equipment. We determined earlier that the structure of chartered banks assets should be of a liquid nature which corresponds closely to the potential liquidity of their liabilities. Leases and property rights to equipment are at the low end of the liquidity scale and would not meet the criteria necessary to a banking operation which supports monetary principles.

In the second instance, banks are always proposed as a stop gap where a market need appears unfilled. We would argue that there is no evidence that a market gap exists. Furthermore, under present legislation the banks could fill it through their leasing affiliates, although probably with a lower margin than if they did it directly. If bankers claim that their entrance would reduce rates to the customer, why did this not happen when the banks entered the leasing business indirectly or the mortgage market directly? At the same time, bankers affirm that their branch system would make leasing accessible to the masses. The kinds of sophisticates who use financial leases are likely to be in, or familiar with, the major centres. Truly, using the branch banking system and its marketing power as an argument in favour of the banks is not a justification for their involvement in a non-banking function. Much more evidently it is a symptom of the problems of our Canadian financial system: there is currently so much imbalance between the chartered banks and other financial institutions that inevitably banks are prepared to fill an apparent need in the market. This leads to a vicious circle where banks accede to a market which consequently increases their relative power and makes it even less likely for any other financial institution to compete with them in the future.

The real problem is the inequality amongst contenders in the financial system, not the market itself. This inequality would become even more pronounced if banks were allowed into the leasing business directly. Since banks have a lower cost of money than other financial institutions, they could, if they so desired, eliminate all other contenders in the market in the long run. Competition is as essential to the health of the leasing market, as to any other. Healthy competition, however, is predicated on the ability of institutions to maximize resources at the margin where costs should be equal for all firms who operate with equal efficiency. Unhealthy competition generally originates from the presence of one firm or industry which has a net advantage which the others cannot match and which in the long run will eliminate them. One visualizes that chartered banks, by virtue of their lower cost of money, could subsidize their leasing operations to an extent where they would attain monopolistic dominance in the market. If chartered banks were allowed the use of tax write-offs the rapidity of the effect would be even

(1) See Financial Intermediation and the Nature of Banking, Chapter 3.

more dramatic. As Glen Langdon, past President of the recently formed Equipment Lessors Association of Canada, said in an address made in May 1973, the banks ''would have the capability to blow all non bank leasing companies out of the market because of their enormous tax base and their access to the cheapest financing''.

In terms of competition one can see two levels of deterioration following the banks' entrance into the leasing market: firstly, virtually all domestic leasing operations could be eliminated resulting in a severe decline in the level of competition in the leasing market and probably the annihilation of leasing companies as viable financial institutions in the Canadian financial system. Secondly, the added market power of banks would contribute to their relative increase in dominance over other financial institutions since none of these are in a position to penetrate the leasing market as sweepingly as the chartered banks. This leads to a compounded reduction in competition, with no assurance of compensating benefit to the consumer, in the leasing market and in the financial system, which clearly is not acceptable in view of the present level of competition in Canadian financial markets and amongst institutions.

The chartered banks entering the leasing business might finance their activities from their existing liability base or through the issue of debentures. In the first instance the banks would make a portfolio adjustment which would displace other assets, principally term loans; in the second instance the active and continuing presence of chartered banks in the debenture market to finance their leasing operation would create another displacement effect, this time against the other financial institutions in the leasing business. The Canadian chartered banks undoubtedly benefit from some market power advantages in raising funds for their debentures and one might argue that this would result in their paying lower rates for funds which would ultimately benefit the consumer. Unfortunately, the chartered banks entry into the debenture market would increase the demand without necessarily altering the supply level resulting in a price increase. The leasing companies might therefore be placed in a squeeze which would either drive them out of business or allow them to survive marginally by charging a higher interest rate which would be profitable for the banks but expensive to the consumer.

c) The third possibility consists of changing the existing mechanism without allowing chartered banks into leasing. It appears to have all the advantages and none of the disadvantages. By leaving the chartered banks aside, there is no possibility of a market bias or unfair competition originating from the banks size or rate setting. The remaining financial institutions which should be allowed to compete for the leasing business are leasing companies, trust and loan companies, credit unions and other firms whose letters patent and statutes permit them to act as lessors. These institutions are smaller than banks, but relatively closer to one another in size and competitive ability, to the extent that there is no evident market leader and price setter.

These firms could compete both at the consumer and the capital market levels.The Canadian chartered banks' role in this case would be to lend funds to these institutions as a banker and not as a principal, which is what we consider to be the fulfillment of their proper intermediary function.

The remaining aspect which requires attention is the control of foreign bank subsidiaries operating uncontrolled in Canada. These firms are not true banks in that they do not accept demand deposits from the public in general but issue their own debentures or commercial paper in a manner which closely resembles the operations of leasing companies. In view of their predetermined liabilities, they do not need to maintain liquidity other than for regulatory purposes. In fact, according to our interpretation of the nature of banking, their liabilities do not have to maintain monetary characteristics and therefore there is no reason to preclude them from operating as lessors or even from the direct ownership of assets.

The real problem associated with the operations of the foreign owned leasing companies is not in the nature of their activities but in the nature of their capital structure. They should therefore be regulated to maintain the level of liquidity necessary to meet their debt maturities. This can be

imposed on the same basis as for trust and loan companies. In addition, their capital-debt ratios should be regulated. With the safety factor injected in their capital structure, the financial system would have the necessary liquidity and safety margin and the leasing market would gain a viable competitor. As long as these institutions do not become deposit takers in a banking sense, there is no reason to preclude them from leasing.

E. Conclusions and Recommendations

We have reached the conclusion that:

1. Canadian chartered banks should not be allowed to act as lessors

   a) because it is not a true banking function: the resulting direct ownership of goods leads to a potential conflict of interest.

   b) because allowing the chartered banks into a non-banking function has been a traditional stop-gap method to overcome a need in the financial system, when the real problem has been the absence of a viable alternative. It is therefore felt that improving the status of non-bank financial institutions by opening a competitive leasing market to them is a better solution for the leasing market and for the financial system as a whole.

   c) because they may potentially create a situation of unequal competition which may be detrimental to the financial system and Canadian economy in the long-run.

   d) because their entry into the capital markets to seek sources of funds to finance their leasing activities would create undue pressure on other borrowers for that purpose. They could, however, continue to operate as bankers to leasing companies and therefore be a source of funds to the latter.

2. The problems associated with the presence of foreign owned leasing companies are not related to their activities as lenders but to the nature of their capital structure, whereby the high leverage presents certain dangers to the stability of the financial system.

We consequently recommend in regard to the Bank Act:

1. That banks should be precluded for acting as lessors, directly or indirectly.
2. That the Canadian affiliates or subsidiaries of foreign banks and financial institutions be required to maintain liquidity levels corresponding to a proportion of their debts maturing, possibly in a manner similar to the trust and loan company liquidity requirement regulations, and that their capital-debt ratios should be regulated.

4. FACTORING

A. The Issue:

Chartered banks in Canada have indicated that the next revisions to the Bank Act should allow them to act as factors. The question therefore is whether banks ought to be allowed to act as factors and compete with other financial institutions directly or whether this market should be reserved for non-bank financial intermediaries.

B. Background

Factoring became a popular corporate source of funds in the early sixties when the first signs of a monetary squeeze forced many firms to go beyond their existing credit lines and seek some more imaginative sources of funds.

A firm may factor its accounts receivable by transferring title to these to a third party. The purchaser of the accounts generally provides the seller with cash based on a discounted value of the receivables. On small sums, the purchaser of the receivables would typically pay the face value of the receivables less, say 2%,and charge the seller an interest rate on the balance until the accounts are collected. The rate is charged on the declining balance at something over prime. The discount charged by the purchaser varies directly with the credit worthiness of the vendor and the nature of the account payable itself. The amount which is charged over prime as an interest rate on the declining balance varies with the volume handled and the credit worthiness of the firm whose accounts are being factored.

The purchaser of the receivables may wish to retain recourse on delinquent accounts, in which case he turns these back to the vendor for collection and reimbursement. Normally, factors prefer to retain the recourse clause although in some circumstances they will purchase the accounts receivable outright without it. In the latter case, the factors absorb the full risk of the collection of receivables, which is reflected in a deeper discount.

Factoring provides the firm that sells its receivables with a one time increase in cash and consequently an improvement in liquidity. There are two advantages for a firm which factors its receivables; firstly, it obtains its cash upon delivery and acceptance of goods which will be paid by the receiver to the factor at his own convenience. Thus, firms with reasonably high profit margins find it worthwhile to sell their accounts at a discount to a factor in order to maintain liquidity. The second advantage is that the firm factoring its accounts need not have an accounting staff in charge of receivables and collections since it passes this function on to the factor.

Factoring firms have grown in number substantially since the beginning of the decade with over fifty firms specializing in factoring in Canada and numerous others offering it as one of their financial services. It is worth noting that chartered banks, though not directly involved by virtue of statutory provisions, have acquired interests in factoring companies. At the same time, quite a number of foreign financial institutions that have established offices or affiliations in Canada also provide factoring services.

C. The Possible Choices:

The choice is whether or not chartered banks should be allowed to act as factors.

D. Implications:

Factoring entails a process whereby the factor takes over administration and title to accounts receivable, and consequently performs an integral part of the firm's ordinary accounting function. There are four aspects which deserve consideration:

a) Some would argue that the operations of a factor do not retain the flexibility of normal bank credit procedures. A demand loan remains callable at the discretion of the banker while

discounted invoices pass in title and consequently lose that flexibility. This is a thin argument since factoring contracts may be rescinded at very short notice. From a financial point of view, factoring represents no more than the discounting of a promissory note. The promissory notes which accounts receivable represent vary in maturity according to the creditors' payment procedures but seldom exceed ninety days. Factoring may therefore be considered as short term discounting which is an allowable banking function according to the definition of banking as we have determined it in a prior section. With accepted delivery and invoicing there is no ownership of goods associated with the operation and therefore it qualifies as a banking operation.

b) In the second case, some have argued that monetary policy is less effective on factors than on banks financing receivables and inventory through short term demand loans. As far as credit constriction is concerned the retraction of a factoring arrangement is generally just as simple as the calling of a loan. Interest elasticity also operates directly via the rate of discount charged by the factor for the purchase of the accounts and via the rate of interest charged on the outstanding balances. Since the firm's credit alternative is to finance receivables through short-term bank loans which are less expensive than the factor's rate, chances are that the pressure of rising interest rateswill be felt more strongly by firms factoring their receivables than by firms financing them through short-term bank loans.

c) In the eyes of some people, the chartered banks' direct entry into the factoring field encroaches on the non-banking sector with a powerful marketing advantage which may lead to undue influence by banks upon firms. We do not find this convincing, given the similarity between factoring a firm's accounts receivable and supplying the same firm with a callable loan.

d) The last point to consider and probably the most valid is that the chartered banks' direct presence in factoring will cause a strong market pressure on other factoring firms. Realistically, the banks' market position as well as their cost of money could place them in a position where they could virtually eliminate the competition in a relatively short period of time. The problem which must be resolved therefore is whether or not the potential loss or decline of factoring firms is of greater value than the gain achieved through the widespread dissemination of factoring facilities. In truth, since most factors are currently bank connected or affiliates of foreign financial institutions, it would only really harm the small independent factors who are not responsible for a large percentage of the total factoring volume. Consequently, we must assume that the entry of chartered banks into the factoring market may mean the ultimate demise of small independent factoring firms.

E. Conclusion and Recommendations

We conclude therefore that Canadian Chartered banks as well as other qualified financial institutions are entitled to carry out factoring operations since:

1. factoring can be considered as a normal discounting procedure;
2. monetary policy would not be impeded;
3. chartered banks specifically would not wield greater power as factors than as short term lenders against receivables:
4. the effect on factoring firms could be harmful only to the small independent operators.

Consequently we recommend in regard to the Bank Act:

1. That Canadian chartered banks be allowed to act as factors.

5. THE UNDERWRITING FUNCTION AND THE SALE OF SECURITIES

A. The Issue:

Given the present institutional structure of our financial system and the anticipated needs for underwriting and secondary market services, which intermediaries should be allowed to perform the underwriting function, and which should conduct transactions in the secondary securities market?

B. Background:

The underwriter performs an intermediary function by making a wholesale purchase of securities and distributing or retailing it to individual investors and institutions. The investment house serves as a transaction intermediary between holders of securities wishing to sell and buyers. Normally as a matter of internal organization, an investment house will have separate departments, or separate organizations specializing in underwriting, bond sales and stock sales.

In Canada the underwriting and security selling functions are carried out by specialized firms generally referred to as underwriters and investment dealers. Investment dealers maintain offices in all major urban centres of Canada. Most firms centralize their underwriting activities in the larger cities, and traditionally, firms wishing to sell their equity or debt to the public deal directly with the main offices of underwriting firms. The other offices serve as distribution and selling centres. Sales activity is generated most heavily around the exchange markets of Montreal, Toronto and Vancouver.

C. The Possible Choices:

The possibility open to consideration as an alternative to the present system is to allow another financial intermediary to become either or both an underwriter and a seller of securities. Since trust companies' fiduciary functions necessarily include them in portfolio management, and as trustee of corporate debt, they could not be an eligible alternative and do not wish to be. The other major intermediary institutions to be considered are the chartered banks. We shall therefore examine the expected effects of allowing chartered banks into the underwriting field and into the sale of securities to the public.

D. Implications:

The chartered banks maintain a large number of branches geographically distributed throughout Canada, in addition to their foreign offices and affiliates. The extent of their branch network has been the banks' main argument to support their claim to perform an underwriting function and to sell securities to the public directly.

There are two distinct activities to be examined. Underwriting differs from selling securities in the secondary market. In fact, there are grounds for stating that there is a potential conflict of interest implicit in undertaking both activities in respect of the same security. It is true that in certain remote points of our country there might well be a bank branch but no investment dealer's office. Thus, one might think that remote area accessibility to securities transaction facilities would provide a social benefit, which would argue in favour of the banks' entry into secondary market selling.

With respect to direct selling to the public, access to an intermediary in the same city or town would be more convenient, but is in no way essential to securities trading. The number of people in Canada that do not have access to securities information or transaction facilities physically or through well serviced telephone, telecommunication or mail services is negligible.

To turn from sales to underwriting, firms or individuals who wish to have securities issued or a portion of their holdings marketed publicly will always have to deal directly with the main offices

of underwriters where specialized and highly skilled staff are present.

Thus, in the underwriting area,the banks' branch network becomes immaterial. Underwriting decisions would continue to be made centrally if the banks were involved, because the specialized expertise required would not be efficiently employed if spread throughout a branch system.

In addition the branch network argument is subject to the same fallacy of short term expediency overriding long term benefit that we have outlined earlier. If bank branches are permitted to sell securities,the financial base of the investment dealers will be eroded and the latter will have no incentive or financial capability to expand their own branch network.

Relevant to both arguments, but not conclusive in itself, is the fact that banks do not have the necessary qualified staff to upgrade the current level of information and service. Any improvement would require extensive retraining at the branch level in order to make the branch system of the banks viable as an alternative. We therefore conclude that the initial attraction of the banks'branch system as an alternative network for the sale of securities or for underwriting loses much of its force when properly analysed and that it would dilute the present system, rather than provide a net benefit.

From a more fundamental viewpoint, we should review the economic and conceptual issues associated with allowing chartered banks into a sales and/or an underwriting function. Perhaps the best approach is to benefit from the experience of the United States where the exclusion of commercial banks from the securities business has been legislated. The congressional purpose underlying the Glass-Steagall Act is summarized by the U.S. Supreme Court in one of its judgments as follows:

> ''Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment banker's primary stake in the success of particular investment opportunities were destructive of prudent and disinterested commercial banking and of public confidence in the banking system''.(1)

The two basic reasons for keeping banks out of underwriting and the sale of securities are potential conflict of interest and the fact that they are not banking functions. As pointed out in our section on intermediation and the nature of banking, underwriting and the sale of securities do not qualify as banking activities, though they are intermediation functions, since they are not functions which pertain to monetary characteristics and lead to dual profit motives. The same ruling of the U.S. Supreme Court further elaborates:

> ''In any event we are persuaded that the purposes for which Congress enacted the Glass-Steagall Act have no room for the conclusion that a participation in a bank investment fund is not a security within the meaning of the Act. From the perspective of competition, convenience and expertise there are arguments to be made in support of allowing commercial banks to enter the investment banking business. But Congress determined that the hazards outlined above made it necessary to prohibit their activity to commercial banks. Those same hazards are clearly present when a bank undertakes to operate an investment fund''.(1)

The quotation above makes two essential points which are relevant to our Canadian situation. In the first instance, for the same reason we have outlined, it considers the negative aspects of banks' involvement in investment banking and dealing in securities to be greater than the possible advantages derived from greater distribution, convenience and competition. We believe that the same applies in Canada. In the second instance it extends the prohibition to the operation of an

(1) Investment Companies Institute v. Camp, 401 U.S. 617

investment fund. The underlying logic states that if the Glass-Steagall Act disqualifies the sale of securities by commercial banks there is no reason why this ruling should not also disqualify them from operating an investment fund and consequently the sale of mutual fund units.

It should also be remembered, as has been pointed out previously, that allowing chartered banks into non-banking activities merely by virtue of the extent of their branch network is not a logical step. To the contrary, if we legislate to allow access to intermediary functions such as underwriting by chartered banks, we will forever eradicate any possibility of a specialized financial institution developing profitably and consequently we will perpetuate and guarantee the imbalance existing in our financial system.

Ideally, underwriters and investment dealers will develop an active intermediation function which will be supported by the banks in their complementary monetary function, with the relationship remaining as between borrower and lender, not competing intermediaries.

The current state of development of the underwriting and security selling industry in Canada may make it difficult for dealers to fully absorb the volume and fulfill the needs of the capital market. We anticipate, however, that they may be brought through a growth pattern which will enable them eventually to absorb the full volume of business in Canada on all securities markets. If underwriters and dealers could benefit from a profitable growth oriented environment they could develop into a viable set of professional financial institutions properly performing a definite and critical role in the development of the Canadian economy.

We respectfully suggest that the enhancement of the position of investment dealers as positive contributors to the financial system is a matter for the government and the Bank of Canada, whereby each one could consciously contribute to giving the industry the strength which it presently lacks and which is definitely required to meet the needs of our capital market. Circumstances may warrant therefore, that until the investment dealers have gained the necessary status, chartered banks may be allowed, as a matter of expediency, to become underwriters in the government sector, i.e. for securities which are direct obligations of, or guaranteed by, federal, provincial or municipal governments. This restricted area of activity would limit the potential for conflict of interest and would also open up the essential direct access to large sums of money for the borrowers.

E. Conclusions and Recommendations

We can therefore conclude that in the long-run chartered banks in Canada should not be permitted to act as underwriters, sellers of securities, operators or distributors of investment or mutual funds. We recognize, however, that immediate needs may justify the banks' involvement as underwriters or sellers of government securities only. These conclusions have been reached on the grounds that:

a) they are intermediary but not banking functions;
b) such activities may lead to a potential conflict of interest for banks;
c) they are functions which are already provided and the long-run participation of chartered banks would not provide a net social or economic benefit;
d) the banks' proper role is to finance investment dealers in a true banking fashion and not to duplicate their function.

Consequently, we recommend in regard to the Bank act:

1. Canadian chartered banks should not be allowed to act as underwriters or sellers of securities directly, or indirectly as operators or distributors of a mutual fund, with the specific exceptions of Canada, provincial and municipal securities and guarantees.

5. INVESTMENT ADVISORY SERVICES

A. The Issue:

Which, if any, financial intermediaries should be permitted to offer investment advisory services and solicit investment management accounts. More specifically, should chartered banks be allowed to enter these fields?

B. Background:

Investment advisory services are available to the individual and to financial institutions from the following sources:

a. Investment counsellors who develop research facilities as a prerequisite of their function of the investment management of individual and corporate portfolios. These firms may in some cases extend advisory services to non-clients as well as clients. Normally this is done on a fee for service basis.

b. Stockbrokers and investment dealers, who undertake a research function to support their sales operation and inform their salesmen. This information is available to customer and non-customer alike, normally on a complimentary basis.

Other large financial institutions maintain their in-house research facilities to provide them with cross-references and a capacity for comparative judgement. Trust companies and life insurance companies, for example, are necessarily involved in investment research for the portfolios that they manage, and for Company Account. Chartered banks require research for their own portfolios, which are significant, and to support their economic planning.

C. Implications:

The ideal of the total independence of the advisor from the client is unattainable in the present financial system. We suggest that objectivity is and always will be relative, but that those presently engaged in the giving of investment advice, and/or management of investment portfolios are well aware that their continued survival can be prejudiced by allowing bias to cloud their judgement, and cause the giving of improper recommendations. Recent emphasis by clients on measured investment performance makes this a constant preoccupation of advisers and managers.

We recognize, therefore, that potential conflicts of interest can arise within the framework of the existing relationships. Nevertheless, we suggest that such potential conflicts are magnified for the chartered banks, by reason of the quantity of confidential information that they require from corporate clients in order to carry out prudently their prime function of short-term commercial lending.

Security regulations in sophisticated financial communities have attempted with varying degrees of success to deal with the problem of ''inside'' information, and the conflict of interest arising from the improper use of confidential price-sensitive information. The entire ''Chinese Wall''[(1)] concept and the volume of U.S. litigation provide evidence of the magnitude of the problem.

Once more the expediency argument implicit in making use of the chartered banks' extensive distribution network assumes that it would be a benefit to the public at large if investment advice could be made available through the branch system. The questions to be answered are therefore whether the banks could improve the quality of service to the public and whether authorities would therefore find it expedient to let the banks into a non-banking activity, a move which would

(1) For explanation of ''Chinese Wall'' concept see section entitled ''Banks and Trust Powers''

not only further erode the financial base of the investment advisory industry but also aggravate and perpetuate the competitive imbalance within the financial system. There are therefore cogent arguments against permitting banks to offer investment advice, or manage investment portfolios. These are as follows:

a. Firstly, there is the potential conflict from information available to the banks as a commercial lender. The chartered banks would undoubtedly make every effort to separate their lending and investment functions, but we suggest that the potential danger of their being unsuccessful in this regard is ever present, and any change to this effect, even if groundless, would be a severe blow to public confidence.

b. The power that the banks would wield by recommending one security over another would create an enormous information bias and market disequilibrium. Information originating from even one bank would have greater popular dissemination than that of all current advisory firms.

c. Their entry in the field, because of its scale, would increase the institutionalization of the market, the present extent of which is already causing some concern.

d. The investment advisory function is not bank-related. This argument is the most convincing: a true banking function which consists of maintaining transactions balances and some savings and which is required to hinge around a monetary economic function should not be over burdened by unrelated client service functions. In short, it is a totally unnecessary addition, not only to their present activities, but to the kind of services that a true bank should offer.

   There is, of course, no objection to banks providing ad hoc investment advice at a client's request and normally banks refer clients to specialists in the field.

e. Some non-bank financial intermediaries are required to provide investment advice, by reason of the nature of their business, as is indicated above in the case of stockbrokers and trust companies. Because of their history in estate, trust and investment administration, and the regulatory constraints under which they operate, trust companies are probably the best suited of deposit-taking institutions to provide client advice.

D. Conclusions and Recommendations

In accordance with the arguments presented above, we conclude that Canadian chartered banks should not be allowed to promote investment advisory services or solicit investment management accounts. This conclusion was reached principally because investment advisory services are considered to be unnecessary and unrelated to the banking function. They are presently adequately provided by other research firms and non-bank financial intermediaries.

Consequently we recommend in regard to the Bank Act:

1. Canadian chartered banks should be precluded from the active promotion of investment advisory services and the solicitation of investment management accounts, whether to clients or the public at large, and whether directly or indirectly.

APPENDIX I

Methodology and Statistical Sources

The statistical bases for Tables I to XX originate from the Statistics Canada **Financial Institutions: Financial Statistics,** Catalogue 61-006, published quarterly, or from **Public Accounts,** Ottawa, Queen's Printer, published annually. The tables contain either direct reproduction of these figures or derivations using these same statistical bases.

Statistics Canada assembles as broad and regular a data base as feasible. Undoubtedly, in the aggregation process, some accuracy may be sacrificed because of variations in accounting techniques among the sample of firms. The data is gathered, however, with a great deal of care to avoid instances of duplication of information or double counting by taking into account parent subsidiary relationships or the possibility of the same company filing under more than one classification.

Hereunder we have reproduced the statement of procedures and sources as it appears in Financial Institutions—Financial Statistics. This statement we believe contains all the information necessary to corroborate and explain the major data base utilized in our submission:

> "Corporations and financial institutions submit financial data directly to Statistics Canada on a quarterly basis. While it may be desirable to obtain returns from every firm operating in Canada, the cost and resources involved in compiling, collecting, analysing and aggregating such a mass of statistics dictates the utilization of sampling and statistical techniques, particularly in industry groups comprising numerous small firms.
>
> "All large corporations are required to submit a return each quarter. For the balance of the companies, sampling techniques are utilized. The present sample is stratified into four size groups. The greater the total assets of a firm the larger the percentage of firms that are required to submit returns in that size stata. Conversely, the smaller the total assets, the smaller the percentage of firms required in the sample.
>
> "In most industry groups, each category in the balance sheet, revenue, expense and retained earnings statements are linked by size strata and by industry group directly to annual national revenue tabulations which cover all corporations in Canada submitting income tax returns. Quarterly sampling data by size strata and by industry group are then blown up to universe proportions, category by category on the basis of each category's relationship in the sample to the universe data. The resultant estimates for each category are revised (rebased) annually on the basis of the more current year national revenue tabulations.
>
> "National revenue universe base data are adjusted quarter by quarter to reflect the structure of the industry as it is made up in the quarter under consideration. This involves adjustments for reclassification of companies into or out of the industry group, mergers, spin-offs, consolidations, deconsolidations, etc.
>
> "In some industry groups, national revenue tabulations do not represent the entire industry. In such cases, a universe must be developed in order to have a universe base for the quarterly series. An example of this would be the local credit unions series. For this series an annual census is conducted by officials of the department responsible for the regulation of credit unions in each province. Once these data are collected and compiled, each provincial department forwards the data on a national standardized form to Statistics Canada for further analysis and publication of an annual national report on credit unions in Canada. The quarterly data is tied to these annual series and then blown-up on the basis of the quarterly base period figures to the universe base figures.
>
> "The data for the "Movement of Funds" statement are calculated from balance sheets and income statements which are reported quarterly to Statistics Canada. Every attempt is made to determine true flows from the information collected but total sources of funds and total

applications of funds are not published as such on a quarterly basis as this would require a duplication of almost every category in the "Movement of Funds" statement. As a result, the decision was made to distinguish the most common sources and applications and maintain this segregation quarter by quarter. Users of this data who wish to utilize total sources and applications of funds may do so by rearranging this table. Total sources of funds may be obtained by picking up all positive items in the "Source" section and all negative items in the "Application" section. Total application of funds would consist of all positive items in the "Application" and all negative in the "Source" sections.

"National Accounting Reconciliation

Under present methods of national accounting, the operating results of all corporations within the nation are summarized. Due to conceptual differences between national accounting and business accounting, particularly in the area of non-cash outlays, the respective profits do not directly conform. To reconcile these two profit concepts, the following procedures may be utilized:

Industry net profit

Add:

- current income taxes
- deferred income taxes
- depreciation
- depletion
- provision for (transfer to) reserves

Deduct:

- dividends received from Canadian corporations
- capital gains reported as a revenue item
- charges to reserves and actual losses and write-offs charged as expense items
- capital cost allowances

Approximates:

National Accounts Corporation profit before taxes.

Other national accounting conventions, such as the elimination of charitable contributions as expenses, affect profits to a lesser degree.

"List of Groups

The following is a tentative list of financial institutions or financial intermediaries which are or will be included in this publication:

- Chartered banks
- Life insurance companies
- Fire and casualty insurance companies
- Trust companies
- Mortgage companies
- Local credit unions
- Central credit unions
- Investment dealers
- Sales finance and consumer loan companies
- Business finance companies
- Mutual funds
- Closed-end funds
- Investment-management companies
- Real estate operators and developers
- Agents and brokers
- Miscellaneous financial companies.

"Definition of Groups

"Fire and Casualty Insurance Companies

This group covers fire and casualty insurance companies (including Canadian reinsurance companies) operating in Canada under the Canadian and British Insurance Companies Act, the Foreign Insurance Companies Act, and corresponding provincial legislation. Accident and sickness branches of life insurance companies are not included nor are the numerous but very small or local or parish mutual companies.

"Trust Companies

This groups includes all companies incorporated under the Trust Companies Act of Canada and corresponding provincial acts.

Balance sheet and income statement data includes both company funds (shareholders' equity) and guaranteed funds (deposits and certificates). Estate, trust and agency funds are not included.

"Mortgage Companies

This group consists of all companies incorporated under the Loan Companies Act, savings certificate companies and other companies which raise funds from the public (either directly or through publicly owned parent companies) primarily for mortgage lending activities. Privately financed mortgage companies are not included in this industry group.

"Local Credit Unions

This group includes all credit unions chartered by provinces to carry on credit union activities within the respective province except inactive credit unions, the majority of which have had their charters cancelled.

"Central Credit Unions

This group consists of leagues and other organizations that are organized as a central body to perform such services as accounting, financial, credit investment, etc., for local credit unions as members of the league. In most provinces there is only one such central body whereas some provinces may have as many as 5 or 6, each having its own local credit union membership. Central Credit Unions generally provide services only for the local credit union organization but there are also Centrals that deal directly with individual credit union members.

"Sales Finance and Consumer Loan Companies

This group covers firms which are in the business of financing goods and services purchased at the factory, wholesale, or retail levels and of lending money to persons on the security of promissory notes and chattel mortgages. Included in this latter category are the companies operating under the provisions of the Small Loans Act. Excluded from this group are: wholly-owned subsidiaries which have been formed to finance only the goods and services of the parent company: companies primarily engaged in lending activities to corporations such as factoring companies and hold-management companies; and companies engaged in financing home improvement purchases. This group as herewith defined covers approximately the same firms as those in the "Credit Statistics" publication.

"Sales finance and consumer loan companies were combined in the one group when it was found difficult to separate the activities of the two groups. Most firms carry out both activities either as divisions or through wholly-owned subsidiaries. Where the activities are carried out through wholly-owned subsidiaries the parent company generally submits a consolidated return.

“Mutual Funds

This group includes those firms which have their major assets invested in a portfolio of various types of securities and in which the public may purchase any desired number of shares at a price fixed in relationship to net asset value, and redeem any number of shares held at net asset value. Because the number of outstanding shares constantly changes with purchases and redemptions of shares by each individual investor, the companies in this group are commonly referred to as open-end funds.

“Excluded are those funds set up to operate pension plans, special non-resident owned funds, investment clubs, and other mutual funds the shares of which are not available to the general public.

“Closed-end funds

Closed-end funds have a common feature with mutual funds in that their major assets consist of investments in securities. Investment policies and objectives of many of the closed-end funds are also similar to those of the mutual funds. However, when an investment corporation exists primarily to gain control and provide management it is excluded from this group. Because of the various degrees between these two objectives—investment or control—and also because objectives often change, it is difficult to precisely define this group. We have, therefore, closely followed the group of closed-ends funds listed in the Financial Post Survey of Investment Funds. The user of this data is cautioned to the fact that reclassification into or out of this industry of a few companies could change drastically the published figures.

“The main difference between this group and the mutual funds is the fact that shares of closed-end companies are not redeemable by the company at net asset value. Share capital is set up as in an ordinary limited corporation. Once the shares have been offered to the public, the number of outstanding shares remains constant. Shares of such corporations may be purchased only from existing holders and owners of such shares must find a buyer if they wish to sell their shares.

“Investment Dealers

This group includes firms which act as principals in the underwriting and trading of securities. Stockbrokers and, where possible, the brokerage business of investment dealers are excluded. Where investment dealers do not maintain separate accounts for their brokerage business, total operations of the firm are included.”

Tables XXII and XXIII deal with profitability of trust and loan companies and of mortgage companies' performance spreads and with the relative performance of trust and loan companies and chartered banks.

There are two sets of sources for these tables, the first one is the Statistics Canada Financial Institutions: Financial Statistics catalogue which is the source for all trust and loan companies figures and the second source is the Bank of Canada Review which served as the main source for chartered banks statistics. In the case of the Bank of Canada, their source originates from the Department of Finance, annual reports of the chartered banks. The following comments appear on the series used: Since 1965 all banks have ended their years on October 31st... Figures for earlier years are shown on a comparable basis.

- Income from securities excludes realized profits and losses on securities held in investment account which are included in the item “Loss experience not included in other operating expenses”.
- Other operating expenses include provision for losses based on five year average loss experience; in 1974 this amounted to $120.3 million or 0.242% of related loans.

- Total expenses and balance of revenue are shown before provision for income taxes and appropriations for losses other than those included in "other operating expenses".
- Appropriation for losses, net, include general and tax paid appropriations for losses after any transfers out of accumulated appropriations for losses to undivided profits or account."[1]

The reader should be alerted to the fact that Statistics Canada and the Bank of Canada have attempted to standardize their methods of collecting and reporting data to the extent that we believe this makes the figures available from both sources comparable for our present purposes.

Methodology

1. Financial Performance Spreads:

Trust companies, mortgage loan companies and trust and mortgage loan companies combined:— This table is intended to isolate the financial intermediation operation of trust and loan companies from their other revenue creating activities. Financial revenue is derived by deducting average financial liabilities from average financial assets. Since the total financial revenue is earned over a period of one year with an increasing level of assets and liabilities, the average for the period is meant to provide a more accurate indicator. Earning financial assets include cash on hand or demand deposits, investments in Canadian securities and government bonds, mortgage and sales agreements, Canadian preferred and common shares. The borrowed funds consist of chequing and non-chequing deposits, term deposits, bank loans and other loans and notes payable. Financial revenue is all revenue connected with the above assets and financial costs are the costs of the borrowed funds. The difference between financial revenue and financial cost provides us with the financial earnings. The financial revenue to average financial assets ratio gives us the average return on financial assets, the interest expense to average of financial liabilities gives us the average cost of financial liabilities. The difference between the two gives the gross spread from financial intermediation operations.

2. Return on Equity:

Calculations are based on statistical information available from Financial Institutions: Financial Statistics — Statistics Canada catalogue 61-006, Quarterly issues from 1967-1974. The data are the same as used in the spread calculations and therefore provide a comparable base.

In both the mortgage companies and the trust companies' case, total average assets were calculated as well as total average equity. The equity comprises share capital, contributed surplus, investment and mortgage reserves, tax paid reserve fund and retained earnings. In order to obtain a conservative estimate of the trust and loan company industry's profitability we have taken operating income only less taxes paid as the basis to compute net after tax return on average equity.

3. Return on Assets:

Statistical information used in the same as for the above items. Return on average of total assets is arrived at by calculating the ratio between average total assets and operating income after taxes for the period.

---

[1] Source: **Bank of Canada Review** p.S169

4. Return on Equity of Chartered Banks

The method used in calculating the return on equity of chartered banks is meant to approximate as closely as possible that used to compute the profitability of trust and loan companies. Statistics employed are from the Bank of Canada Review, Tables A4 and A5, listing "Chartered banks: Revenue and expenses" and "Chartered banks: Shareholders' equity and accumulated appropriations for losses". Data available from Bank of Canada sources are meant to be consistent with Statistics Canada financial information and consequently the comparability between the trust and loan industry and the banking industry is enhanced by using the same statistical base.

We strove to achieve direct comparability and we also used a method of evaluating bank profitability that was both conservative and acceptable to financial analysts specializing in the analysis of financial institutions. As in the case of trust and loan companies, we have used an approach aimed at reflecting the operating profitability of the industry on a long run basis.

The numerator which represents the revenue figure consists of balance of revenue less income taxes paid as per table A4 of the Bank of Canada Review. Balance of revenue figures include income from loans and securities, and other operating income. Expenses include interest on deposits and debentures, salaries, pension contributions and other staff benefits, property expenses including depreciation on premises, and other operating expenses. In the case of chartered banks, depreciation is not a major item. Other operating expenses, according to the Bank of Canada "include provision for losses based on five-year average loss experience..." We have chosen not to include special contributions to pension funds since these represent expenditures in excess of normal pension payments and detract from a time image of the operating aspect of the chartered banks. We have also omitted "loss experience not included in other operating expenses" since we suggest that such losses or gains include write-downs or write-ups of securities held by banks at a given point in time and that on an ongoing basis the gains and losses balance out, the best example being found in the years 1970 and 1971 where the revaluation process is exact and reflects economic conditions rather than operating profitability. Thus we felt that including the "loss experience not included in other operating expenses" would have distorted the image for proper operating rate of return analysis and would not have been comparable to the one done for the trust and loan industry. Income taxes stated in table A4 are computed on a flow-through basis and have been used as such.

The denominator representing chartered bank equity capital at work is composed of shareholders' equity, comprising undivided profits, rest account and capital paid up, and of the accumulated appropriations for losses. We felt that accumulated appropriations for losses represent capital truly available to the banks on the same basis as their own shareholders' equity categories and therefore should be treated as such.

In order to obtain an accurate as well as comparable estimate, we have used average equity over the year in which the revenue was earned rather than year-end figures. In a situation where capital is expanding, this should provide a more accurate estimate of profitability.

APPENDIX II

Monetary Variables Definitions

The terms M_1, M_2 and M_3 represent conventional monetary aggregates combining different sets of monetary variables. The figures referred to are those compiled by the Bank of Canada statistics reported under the Schedule Q of the Bank Act[1] They are adusted to incorporate seasonal factors.

M_1: comprises total currency outside banks and total Canadian dollar demand deposits. Available from CANSIM tape series No. B1609

M_2: comprises total currency outside banks and total privately held Canadian dollar deposits. M_2 therefore is larger than M_1 by the amount of privately held Canadian dollar deposits requiring notice of withdrawal. Available from CANSIM tape series No. B1603

M_3: comprises total currency outside banks and total Canadian dollar deposits. M_3 is larger than M_2 by the amount of Canadian dollar government deposits held in the chartered banks. Available from CANSIM tape series No. B1602

---

(1) Source: **Bank of Canada Review** — table S49

APPENDIX III

The Trust Companies Association of Canada is a voluntary organization which was established in 1952. Although not all trust companies in Canada doing a general business with the public are members of the Association, the proportion of business for which the membership is responsible represents in excess of 90% of the total trust business carried on across the country.

Because of the affiliations of a number of its members, the Association, as can be seen from the following list, is also to some extent representative of the interests of the mortgage loan company industry:—

1. Canada Permanent Trust Company Canada Permanent Mortgage Corporation	Toronto, Ontario.
2. The Canada Trust Company Huron & Erie Mortgage Corporation	London, Ontario.
3. Central and Nova Scotia Trust Company	Halifax, Nova Scotia.
4. City Savings & Trust Company	Edmonton, Alberta.
5. Compagnie de Fiducie Nord-Amérique	Montreal, Quebec.
6. Co-operative Trust Company of Canada	Saskatoon, Saskatchewan.
7. Crédit Foncier Franco-Canadien	Montreal Quebec.
8. Crown Trust Company	Toronto, Ontario.
9. District Trust Company	London, Ontario.
10. Eaton Trust Company	Toronto, Ontario.
11. The Equitable Trust Company Fidelity Mortgage & Savings Corportion	Hamilton, Ontario.
12. Farmers & Merchants Trust Company	Calgary, Alberta.
13. Federal Trust Company	Toronto, Ontario.
14. The Fidelity Trust Company	Winnipeg, Manitoba.
15. Fiduciares de la Cité et du District de Montréal Limitée	Montreal, Quebec.
16. Fiducie du Québec	Montreal, Quebec.
17. Fiducie Prêt et Revenu	Quebec, Quebec.
18. Guaranty Trust Company of Canada	Toronto, Ontario.
19. Hamilton Trust and Savings Corporation	Hamilton, Ontario.
20. International Trust Company	Montreal, Quebec.
21. The Lambton Trust Company, Limited The Lambton Loan and Investment Company	Sarnia, Ontario.
22. The Lincoln Trust and Savings Company	St. Catherines, Ontario.
23. The Metropolitan Trust Company Canadian First Mortgage Corporation International Savings and Mortgage Corporation	Toronto, Ontario.
24. Montreal Trust Company	Montreal, Quebec.
25. National Trust Company, Limited	Toronto, Ontario.
26. North West Trust Company	Edmonton, Alberta.
27. Ontario Trust Company	Toronto, Ontario.
28. Pioneer Trust Company	Regina, Saskatchewan.
29. The Royal Trust Company The Royal Trust Company Mortgage Corporation	Montreal, Quebec.
30. Société Nationale de Fiducie	Montreal, Quebec.
31. Standard Trust Company	Toronto, Ontario.
32. The Sterling Trusts Corporation	Toronto, Ontario.
33. Trust Général du Canada	Montreal, Quebec.
34. United Trust Company	Toronto, Ontario.
35. Victoria and Grey Trust Company	Lindsay, Ontario.
36. Yorkshire Trust Company	Vancouver, British Columbia.